Exhibit A-22

INTERNATIONAL MONETARY FUND

WEST BANK AND GAZA

REPORT ON MACROECONOMIC DEVELOPMENTS AND OUTLOOK[1]

June 30, 2014

KEY ISSUES

Context: The political situation is marked by heightened uncertainty. Israel suspended the peace talks that started in July 2013 following the announcement on April 23, 2014 of a reconciliation agreement between Fatah and Hamas, the rival Palestinian factions. A consensus government was sworn in on June 2, 2014, with the intention to hold national elections within six months. Prospects for a resumption of peace talks are uncertain, especially in light of the recent rise in political tensions.

Outlook and risks: With the suspension of peace talks, economic prospects for the West Bank and Gaza have dampened and risks have increased. Much will depend on Israeli and donor actions in the period ahead. A reduction in clearance revenue transfers[2] or donor aid, for example, would increase fiscal pressures and hit the already struggling economy hard. On the other hand, if the peace process was to resume and over time completed successfully, this could lead to reduced Israeli restrictions and would facilitate the launch of donor initiatives and the Initiative for the Palestinian Economy led by the Office of the Quartet Representative (OQR).

Key policy recommendations: Cautious macro-fiscal management and continued structural reforms are critical. For 2014, fiscal measures are needed to fill the projected financing gap to avoid further arrears accumulation. Moreover, the authorities are advised to prepare a contingency plan to respond to rising fiscal risks. The donor community could help by maintaining aid flows to the West Bank and Gaza in present fragile circumstances. Over the medium term, there is a need to move to a more viable financing model, one that combines lower deficits with a growth-friendly reorientation of expenditure and with sustained and predictable donor assistance. A broad-based easing of Israeli restrictions remains a precondition for higher growth and employment.

---

[1] The IMF provides technical services to the West Bank and Gaza, including policy advice in the macroeconomic, fiscal, and financial areas, as well as technical assistance, with a focus on tax administration, public expenditure management, banking supervision and regulation, and macroeconomic statistics (Annex II). See www.imf.org/wbg for recent staff reports.

[2] Clearance revenues are revenues collected by Israel in the form of indirect taxes on imported goods. These revenues are later transferred to the Palestinian Authority.

Approved By
Juha Kähkönen and Ranil Salgado

Discussions were held in East Jerusalem and Ramallah during January 28–February 6, 2014. The staff team comprised Christoph Duenwald (head), Anja Baum, Udo Kock (Resident Representative), and Anna Unigovskaya (all MCD). Juha Kähkönen (MCD) joined the discussions for a few days. The mission met Prime Minister Hamdallah, Deputy Prime Minister Mustafa, Finance Minister Bishara, Palestine Monetary Authority Governor Al Wazir, Minister of Planning and Administrative Development Ramadan, Palestinian Central Bureau of Statistics President Awad, other senior officials, private sector representatives, and donors. The mission prepared a concluding statement and issued a Press Statement. Mr. Kock conducted a second round of discussions in May 2014.

CONTENTS

TABLES

ANNEXES

POLITICAL AND ECONOMIC CONTEXT

1. **Amidst ongoing political uncertainty, economic growth in the West Bank and Gaza (WBG) has been on a steep downward trajectory over the past few years.** Growth was strong during 2007–11, buoyed by large inflows of donor assistance and some easing of Israeli restrictions on movement and access. Growth started to decelerate sharply in 2012, reflecting lower donor assistance and the lack of further easing of restrictions.[3] Amid increasing fiscal difficulties at the start of 2013, rising political uncertainty, and a sharp deterioration of economic conditions in Gaza, growth declined further in 2013 to around 2 percent, the lowest in six years, accompanied by steadily rising unemployment.

2. **In April 2014, the peace talks initiated in July 2013 came to a halt, with the future of the talks uncertain.** After a three-year hiatus, Israeli-Palestinian peace negotiations resumed in July 2013, but the talks were under pressure from the start. Throughout the negotiation process, Israeli settlement expansion into the West Bank and East Jerusalem continued unabated and domestic political opposition to an agreement persisted on both sides. In April 2014, Israel did not release the last group of prisoners and the Palestinian Authority (PA) signed several UN conventions and international treaties. President Abbas' subsequent announcement of a reconciliation agreement between Fatah and Hamas prompted Israel to suspend peace talks.

3. **A new Palestinian government dominated by independents and technocrats and endorsed by Fatah and Hamas was sworn in on June 2, 2014.** Allies in President Abbas' previous government continue in key positions, including Prime Minister Hamdallah, Deputy Prime Minister Mustafa (who will continue to lead on economic policy), and Minister of Finance Bishara (who will also run the Ministry of Planning).

4. **Donors have responded mildly to the new consensus government while Israel has hardened its stance against reconciliation.** The European Union and the United States have indicated their willingness to work with the new government and maintain aid levels. Israel considers Hamas a terrorist organization so will not negotiate with the new government and has indicated its preparedness to impose additional sanctions against the PA. In the past, sanctions came in the form of a reduction of the transfer of clearance revenues. As a result of these developments, and a recent increase in political tensions following the abduction of three Israeli youths in the West Bank, the prospects of resuming peace negotiations have further diminished.

5. **The WBG's risk profile and medium-term economic outlook are heavily dependent on how the political situation evolves**. While the situation remains difficult to predict, staff sees three broad medium-term scenarios:

[3] The Government of Israel emphasizes security concerns that restrict its ability to ease or lift restrictions in the West Bank and Gaza.

- ***Baseline (political status quo).*** It is assumed that efforts to achieve Fatah-Hamas reconciliation continue and that the peace negotiations remain suspended, with neither a complete breakdown in relations nor immediate prospects for resumption. It is also assumed that the risk of major tightening of Israeli restrictions and suspension of transfer of clearance revenues remains, but actual steps taken are limited. In these circumstances, continuing with the present model of large recurrent deficits being financed by unpredictable aid flows and under broadly unchanged policies, implying limited PA reform efforts, would result in growth remaining low, converging to about 3 percent in the medium term, with rising unemployment. This scenario is unlikely to be sustainable over the medium term due to the potentially destabilizing effect of the unresolved conflict with Israel and economic stagnation with rising unemployment. However, under an alternative financing model, involving a shift towards growth-friendly government spending (see also paragraph 26) and some economic reforms, along with easing of Israeli restrictions, economic outcomes would be better. In these circumstances, even a political status quo scenario could be more sustainable, albeit decidedly second best.[4]

- ***Downside (sustained failure of peace talks).*** This scenario assumes that parties give up efforts to resume negotiations, upsetting the political and security status quo and leading to disruption of transfer of clearance revenues or other measures by Israel. Arrears accumulation would accelerate and private sector confidence would drop, hitting the economy hard, especially if donors also signal withdrawal of support. The likelihood of this scenario will increase further the longer the status quo continues.

- ***Upside (resumption and eventual breakthrough in peace talks).***[5] A resumption of negotiations and subsequent breakthrough could allow the Initiative for the Palestinian Economy (IPE) and other initiatives to move forward and provide a large investment stimulus that could boost real GDP growth substantially over time (Box 1). These positive economic spinoffs from a political breakthrough would still require wide-ranging upfront Israeli removal of restrictions and other enabling measures. This scenario could set domestic political conditions for long overdue fiscal policy adjustments, a push by the PA to lessen infrastructural, institutional, and legal capacity constraints, and for donors to re-orient aid to support public investment. The likelihood of this scenario has decreased recently, and will decrease further the longer the status quo continues.

[4] Such a scenario would resemble a more muted version of the upside scenario discussed in Annex I.

[5] An illustrative scenario showing the potential upside for the WBG economy is fleshed out in Annex I.

Box 1. Recent Initiatives to Assist the West Bank and Gaza

Until their recent suspension, the peace negotiations had been the driving force behind a range of independent initiatives to support the economy of the WBG.[1] *The modalities of these initiatives are still evolving, and together they have the potential to provide a powerful impetus to the Palestinian economy, provided there is progress on the peace front combined with up-front Israeli enabling measures. With the recent suspension of peace talks, the status of these initiatives is uncertain. Still, they remain important economic incentives to get the peace process back on track.*

The Initiative for the Palestinian Economy (IPE), prepared by the Office of the Quartet Representative (OQR) Tony Blair, aspires to transform the Palestinian economy through private sector-led growth based on eight sector strategies. The initiative is predicated on a new political reality that includes far-reaching Israeli enabling measures, comprehensive foreign and domestic private sector buy-in, and significant donor-financed public investment. According to staff analysis, the IPE could be a game changer for the Palestinian economy.[2] It would raise employment and household incomes and likely lead to a reduction in poverty. However, there are risks. Public and private sector implementation constraints are likely to dampen the IPE's near-term economic impact. The compressed implementation time, in combination with the multitude of supply constraints, raises the risk of asset price bubbles and high inflation. The envisaged large and rapid increase in mortgage lending—mostly to low-income households—could sharply raise credit risk and reduce banks' asset quality. In addition, there will be governance challenges, relating especially to public investment management and the extended scope of administrative responsibilities. Managing these risks will be a formidable challenge.

The U.S. High Impact Micro-Infrastructure Initiative (HIMII) totaling $100 million involves small scale community based infrastructure projects intended to show tangible benefits for Palestinians as peace negotiations advance. The projects are to be completed within a year and include the construction and repair of health clinics, roads, water systems, community centers, and schools.

Japan's initiative was launched to broaden the support base for the PA beyond the existing AHLC framework. The "Conference on Cooperation among East Asian Countries for Palestinian Development" (CEAPAD) aims to mobilize Asian private sector resources to facilitate knowledge exchange and technical assistance in support of economic development in the WBG.

The EU has announced an "unprecedented" package of support—to Israel and the PA—if a final status agreement is reached, without mentioning specific amounts or modalities. In addition, some donors are mulling a Paris II donor conference to increase financial support if a peace agreement is reached.

The Portland Trust (an NGO) has initiated the "Beyond Aid" initiative that aims to launch private sector investment projects that can be implemented with no need for Israeli enabling measures.

---

[1] Another noteworthy initiative, which in contrast to the other initiatives mentioned here is private sector driven, is "Breaking the Impasse" (BTI), which brings together prominent business people and civil society leaders from Israel and the WBG who are in favor of a peaceful solution to the Israeli-Palestinian conflict.

[2] At the request of the PA and OQR, staff undertook an analysis of macro-fiscal implications of the IPE.

RECENT DEVELOPMENTS AND MACRO OUTLOOK

A. Recent Economic Developments

6. **Economic activity has weakened further** (Figure 1, Table 1)**.** Growth has been on a sharp decline after peaking at about 12 percent in 2011. Preliminary estimates suggest that GDP growth fell from 5.9 percent in 2012 to less than 2 percent in 2013, reflecting mounting political uncertainty, continued accumulation of arrears to the private sector and a sharp deterioration of economic conditions in Gaza from mid-2013 on.[6] The latter followed the closure of tunnels to Egypt—a conduit of cheap imports—by the post-Morsi government, which led to a drastic decline in construction activity, shortages of fuel, and electricity outages in Gaza. On a positive note, WBG exports increased by 10 percent in 2013, with the improvement in net exports contributing 3 percentage points to growth. Israel remained the main destination of exports (82 percent in 2012).

7. **Reflecting weak growth, unemployment continues to rise from already high levels.** Unemployment in the WBG was 26.2 percent for the first quarter of 2014 (18.2 percent in the West Bank, and 40.8 percent in Gaza), remaining broadly unchanged since end-2012 in the West Bank, and increasing by almost 8 percentage points in Gaza. At the same time, youth unemployment reached a staggering 43 percent. In the West Bank, the lack of employment prospects was somewhat mitigated by increased employment in Israel and Israeli settlements in the West Bank, which reached 110,300 in Q1 2014, up by almost 20 percent from Q1 2013.

8. **Inflation remains subdued.** After accelerating in the West Bank from about 1 percent year-on-year in September to 4.4 percent at end-2013, driven mainly by food prices in Israel and reflecting one-off factors, inflation came down to 2.8 percent by April 2014. Gaza experienced deflation until late 2013,[7] but prices are on the rise since the beginning of 2014. Overall inflation in the WBG in April was 1.9 percent in line with low inflation in Israel and supported by the strong shekel.

9. **Business and social indicators remain weak** (Figure 2)**.** While the WBG scores favorably compared to other countries on human development and income inequality, poverty rates are high.[8] This reflects high unemployment and low wages in the private sector, where 39 percent of employees receive less than the minimum wage.[9] The business climate remains poor, despite recent improvements. The WBG ranks 138 out of 189 on ease of doing business, according to the

---

[6] According to preliminary estimates by the Palestinian Central Bureau of Statistics (PCBS) as of May 2014; by these estimates, growth declined from 5.6 percent to 0.4 percent in the West Bank, and from 6.6 percent to 4.6 percent in Gaza. The PCBS is expected to publish revised data for 1994-2012 and full year 2013 data in June 2014.

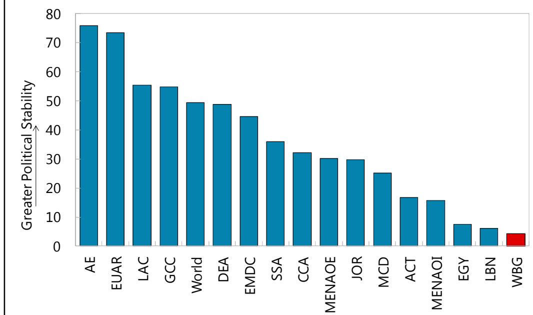
[7] While food prices increased following the tunnel closure, other prices fell, probably owing to the collapse of domestic demand.

[8] In 2011, the poverty rate was estimated at 18 percent in the West Bank and 39 percent in Gaza.

[9] Data for 2013 from the PCBS. The calculation excludes self-employment.

2014 World Bank report.[10] This reflects difficulties in starting a business (high entry costs, large number of procedures and long delays), dealing with construction permits, and protection of property rights. In addition, political instability is high (text chart).

Political Stability and Absence of Violence/Terrorism
(Percentile rank)



Sources: World Bank Worldwide Governance Indicators; and IMF staff calculations.

10. On the fiscal front, there was commendable progress in reducing the overall deficit in 2013 (Figure 3, Tables 2 and 3). The overall deficit, including development spending, declined by 2.7 percentage points (of these, 0.7 percentage points on account of lower development spending) to 13.9 percent of GDP in 2013, following a roughly stable level in terms of GDP during 2010–12. The recurrent fiscal balance was lower than staff projections in the September 2013 IMF staff report by 0.7 percent of GDP, mainly because of better than projected revenue. The improvement in revenue reflected several factors: repayments of overdue domestic VAT and income taxes by several large taxpayers; improved customs revenue from imports of cars; higher clearance revenue from petroleum excises due to growing consumption of fuel in the West Bank; and resumption of imports of petroleum from Israel to Gaza following the closure of tunnels to Egypt. Regarding expenditure, savings on nonwage spending more than offset higher-than-projected wages and net lending. The latter reached 1.9 percent of GDP, reflecting limited progress by the PA in resolving the long-standing electricity nonpayment problem. As in previous years, development spending was far below both budgeted and projected levels.

Fiscal Projections and Outcomes in 2012–13
(In percent of GDP)

	2012	2013 Projections		2013
	Actual	Budget	IMF Sept.	Actual
Net revenues	20.2	22.2	19.5	20.4
Recurrent expenditures and net lending	34.4	31.6	32.4	32.6
Wage expenditures	17.2	16.8	16.8	17.0
Nonwage expenditures	14.4	14.1	14.3	13.8
Net lending (commitment)	2.7	0.7	1.3	1.9
Recurrent balance	-14.2	-9.4	-12.9	-12.2
Development expenditures	2.4	3.1	2.4	1.6
Overall balance	-16.5	-12.5	-15.3	-13.9
Total financing	16.5	12.5	15.3	13.9
External financing for recurrent expenditures	7.6	9.8	10.4	11.1
External financing for development expenditures	1.5	2.7	1.6	0.9
Domestic financing	---	---	3.3	1.8
Net domestic bank financing	1.2	0.7	0.7	-2.2
Arrears	6.7	-0.7	-0.3	4.1
Residual/financing gap	-0.5	---	2.9	-0.1

Sources: Ministry of Finance; and IMF staff projections.

11. Positive revenue trends have continued in 2014, but revenue prospects are uncertain and expenditure growth is rising. In the first quarter of 2014, revenues increased by more than 20 percent year-on-year on the back of strong VAT and clearance revenue receipts, reflecting respectively prepayment of VAT by several large businesses and increased revenues from fuel imports to Gaza via Israeli crossings.[11] In April, however, the growth of domestic tax receipts slowed

[10] The World Bank Doing Business indicators should be interpreted with caution due to a limited number of respondents, limited geographical coverage, and standardized assumptions on business constraints and information availability.

[11] The Ministry of Finance introduced an 8 percent tax discount on pre-paid VAT in 2014.

considerably, highlighting the uncertain prospects for revenue in the remainder of the year. Additionally, risks to clearance revenue have intensified, as Israel may interrupt the transfers of clearance revenue in reaction to the formation of a consensus government endorsed by Fatah and Hamas. So far, the only Israeli measure on the fiscal side has been to marginally increase deductions for repayment of debts to the Israeli Electricity Corporation (IEC). At the same time, current spending (wage and nonwage) accelerated and net lending has shown no signs of abating, reaching 30 percent of the 2014 budget allocation by end-April.

12. Public debt and contingent liabilities of the PA have increased further, pointing to continued fiscal strains and posing risks to debt sustainability. Due to additional support from several donors, total budget support for 2013 reached $1.25 billion, almost $0.5 billion higher than in 2012. This helped to reduce domestic debt and repay wage arrears. At the same time, NIS 1.7 billion (4 percent of GDP) of net new arrears to the Pension Fund and private suppliers accrued during the year, and clearance revenue advances from Israel during 2012 of about NIS 600 million remained unpaid. Additionally, the PA's debt and contingent liabilities to the IEC, some of which are in dispute, have gone up, reaching NIS 1.3 billion at end-December.[12] As a result, public debt, including arrears and clearance revenue advances, is estimated to have reached NIS 16.9 billion ($4.6 billion), or more than 40 percent of GDP, at the end of 2013. It further increased to an estimated NIS 17.4 billion in the first four months of 2014, with domestic debt and arrears rising, amid a cash crunch related to back-loading of donor disbursements towards the second half of the year.

Composition of Net Arrears Accumulation, 2009–13

	2009	2010	2011	2012	2013
	(In millions of NIS)				
Contributions to the pension fund:	526	357	947	1,152	1,250
of which : employee's share 1/	171	185	374	544	612
government's share	355	172	573	608	638
Wage arrears 1/	---	---	---	272	-232
Nonwage expenditures 2/	460	92	353	439	582
Net lending	77	-103	---	---	---
Development projects 3/	118	88	270	124	66
Tax refund	-140	-39	368	239	27
Total	1,040	394	1,939	2,226	1,694

Source: Ministry of Finance.

1/ Item classified under wage expenditures.
2/ Including to private sector suppliers.
3/ Item classified under development projects.

[12] The debt to IEC has risen to NIS 1.5 billion by end-May 2014. About two-thirds of it is attributed to the Jerusalem District Electricity Company (JDECO)—the electricity distributor serving East Jerusalem, Bethlehem, Jericho, and parts of Ramallah. The PA disputes its liability to IEC, arising from JDECO debt.

13. The Ministry of Finance is looking for ways to alleviate the debt service burden. To this end, it has developed, jointly with the PMA, a program of securitization of bank debt with the view to extend maturities from one to three years and to lower interest costs. The cabinet has approved the required legislation and the PA aims to implement the first securitization with a target of $200 million this year. However, the overall effect of debt securitization on the budget is ambiguous, because banks are offered an exemption from the tax on dividends as an incentive to participate in the securitization.[13] The securitization program also aims to facilitate better and longer-term fiscal planning and develop the local capital market.

14. Although bank deposits have been rising, growth in credit to the private sector has been falling, until recently. Reflecting weak demand, growth of private sector credit declined to 11 percent at end-2013, down from over 14 percent at end-2012, but rebounded to 16 percent in April 2014. At the same time, private deposit growth accelerated from 7 percent at end-2012 to 10 percent in April 2014, possibly reflecting increased trust in banks owing to the introduction of deposit insurance, and banks' intensified efforts to attract deposits as they competed for market share and expanded branches. The Palestinian Deposit Insurance Corporation (PDIC) was launched in May 2013, and it is expected to be fully funded over a period of 7 years by mandatory contributions from domestic banks.[14]

15. The banking sector remains healthy under the circumstances, but exposure to the PA and its employees, as well as constraints on Palestinian banks' cash management, raises banks' risk profiles (Figure 4, Table 4)**.**[15] As of end-March 2014, the CAR (Tier I capital to risk weighted assets) remains above 20 percent, NPLs are under 3 percent and profitability is stable, with return on assets at 1.9 percent. Most of the NPLs (60 percent) are concentrated in real estate and trade finance. The banking system continues to exhibit resilience to delinquency of the biggest borrowers and to minor political and economic shocks, according to the latest PMA stress tests. However, loans to the PA and its employees account for a large share of banks' total domestic assets (nearly 43 percent), and stress tests show that a delay in payment by the PA on 40 percent of their outstanding loans could push the CAR below 10 percent. The banking system is liquid, but restrictions by Israel on amounts of NIS cash conversion by Palestinian banks to accounts in Israel contribute to excessive cash accumulation, hurting financial intermediation and banks' profitability.[16] According to the Bank of Israel (BOI), during

---

[13] A better targeted measure would be an exemption of interest earned (net of costs) on the securitizations from corporate income tax.

[14] The PDIC covers deposits under $10,000, which is effectively 93 percent of all deposits, and is financed by a tax of 0.3 percent on eligible deposits, imposed on deposit money banks. Banks will also pay an annual subscription of $100,000 per bank for this fund. The government is expected to contribute $20 million towards capital of the PDIC. The PMA, on behalf of PDIC has approached some donors and central banks to provide a stand-by credit facility to strengthen the PDIC's finances.

[15] The banking system is relatively small with total assets estimated at about 95 percent of GDP. It comprises 17 banks, of which 10 are branches of foreign-owned banks, mostly Jordanian (8). The local banks are privately owned.

[16] Israel restricts the amounts of NIS cash conversion by Palestinian banks. Monthly shipments of cash to Israel were raised from NIS 120 million to NIS 300 million in September 2013, but they have been insufficient to accommodate the

(continued)

the next few months Palestinian banks will be able to deposit the regular quota agreed by the BOI and the PMA in 2013, and the banks will be able to deposit additional large sums of cash on top of the regular quota.

B. Outlook and Risks

16. The near-term outlook remains challenging in any scenario. In a baseline scenario assuming limited policy actions by the PA, no broad-based easing or strengthening of Israeli restrictions, and total donor aid for recurrent and development spending at US$1.3 billion, real GDP growth is expected to remain modest at 2 percent in 2014. With weak growth, unemployment is expected to rise further, to around 27 percent. Inflation will remain benign in line with projected low inflation in Israel, and reflecting global commodity trends. Based on the 2014 budget, a fiscal consolidation of 0.6 percent of GDP will be achieved mainly on account of revenue administration measures and reduction in fuel subsidies, while other spending is projected to increase (see next section). With that, a financing gap of nearly $300 million is projected. In the absence of further adjustment or donor support, the gap would likely be covered by further arrears accumulation and domestic bank borrowing.

17. Beyond 2014, the high degree of political uncertainty implies a wide range of possible economic outcomes. In the staff's baseline scenario, efforts to resume peace talks continue, resulting in limited policy action, while donors maintain current aid levels in the context of the current fiscal financing model. In this scenario, the economy will stagnate and unemployment will continue to rise. The main risks, upside and downside, emanate from the direction of the peace process. A breakthrough could be followed by increased donor aid and the implementation of donor initiatives, provided Israel lifts restrictions. However, should the process remain stalled with a fading likelihood of resumption, the opposite outcome is likely—more restrictions, potential interruptions in clearance revenue, less aid, low or even negative growth, and rising unemployment. This would produce an environment that is ripe for social unrest and a rapid deterioration of the security situation. On the other hand, the switch to an alternative fiscal financing model—as discussed earlier—would improve economic outcomes even in the political status quo scenario.

18. There are also other risks, aside from political uncertainty. The already large fiscal financing gap could further widen if a possible reconciliation between Fatah and Hamas quickly translates into absorbing large numbers of additional civil servants while revenues from Gaza to cover their salaries are slower to materialize. Fiscal risks also increase when aid falls short (possibly because donor aid is diverted to other conflict-stricken countries in the region or reduced in the wake of the Fatah-Hamas reconciliation agreement), in case of an inability to contain fuel subsidies, overspending on wages and transfers, higher net lending to cover electricity costs, and delays in clearance revenue transfers. This could lead to more arrears, and in the extreme case, to a breakdown of essential government services and social instability. A fiscal crisis could also spread to banks, which are heavily

---

large amount of cash deposits in Palestinian banks. Israel lowered cash shipments in May to NIS 200 million after the peace negotiations were suspended, but resumed to previously agreed cash shipments in June. .

exposed to the PA and its employees. Among global and regional risk factors that could affect the outlook are oil price increases, a slowdown in Europe that would affect Israel, and a crisis in Jordan and related financial spillovers via Jordanian banks.[17] On the upside, should the reconciliation agreement between Fatah and Hamas facilitate the gradual reopening of Gaza's border crossings with Egypt, this would reduce supply shortages in Gaza, thereby raising economic growth and improving employment prospects.

19. The authorities concurred with the staff's scenario and risk analysis. They stressed the central role that the evolution of the political process plays in determining future economic outcomes. In particular, the authorities shared staff's view that a clear breakthrough in the negotiations would be positive for growth, but, equally, that a full collapse would have severe economic consequences. They also noted that in the absence of a political breakthrough, major fiscal reforms, e.g., civil service and pension reforms, would be politically difficult to implement. The authorities further emphasized the need for sustained and predictable aid and the central importance of lifting of Israeli restrictions.

POLICY DISCUSSIONS

A. Fiscal Policy in 2014

20. The 2014 budget implies a slowdown in fiscal consolidation. Under macro assumptions that are broadly consistent with the staff's baseline projections for 2014, the budget targets a similar deficit as in 2013 (Box 2), just under 14 percent of GDP. On the spending side, wage expenditure is budgeted to rise by nearly 5 percent—despite reductions in supervisory and transportation allowances[18]—compared to an increase of only 2 percent in 2013. The budget also assumes a significant rise in transfers and spending on goods and services in excess of the inflation rate, and an increase in development expenditures relative to 2013. At the same time, the budget envisages reductions of fuel subsidies and net lending, the latter supported by the timely establishment of a unit inside the Ministry of Finance dedicated to close monitoring in this area. On the revenue side, the budget envisages an increase in domestic revenues by 7½ percent, based on improvements in revenue administration.

21. Staff welcomed the authorities' consolidation efforts over the past few years, but noted that the 2014 budget implies a significant financing gap. Staff projects a deficit of around 13 percent of GDP, lower than the budget, but with a financing gap of nearly $0.3 billion. Compared to the budget, staff projects a similar increase in revenue, but different projections for expenditure and external budget support. On recurrent spending, staff projects higher net lending owing to the absence of any tangible measures in the electricity sector to achieve the reduction envisaged in the budget. At the same time, staff projects lower development spending based on under-spending in

[17] See Annex II in the Staff Report for the September 2013 AHLC for a discussion of risks.

[18] Regarding the latter, the intention is not to change statutory allowances, but to undertake a review of eligibility with the view to ensuring strict adherence to eligibility rules.

recent years. Staff also expects less external financing than is assumed in the budget. Indications from donors suggest that total financial support will not exceed \$1.3 billion this year (\$1.2 billion for the recurrent budget and \$100 million for development budget). Moreover, about \$100 million of it is earmarked for arrears clearance, leaving \$1.2 billion to finance the overall deficit. External support for development spending is also projected to be lower than in the budget. With regard to domestic financing sources, staff assumes some recourse to net bank financing (\$120 million).

Box 2. Main Parameters of the 2014 Budget

The key elements of the 2014 budget are as follows:

- *Nominal GDP growth* is projected at about 4 percent, composed of real GDP growth of 2 percent (1.9 percent in the West Bank and 3 percent in Gaza) and inflation of 2 percent.
- *Revenue* (excluding tax refund) is budgeted to increase by 7.5 percent, or about 0.7 percentage points of GDP (on IMF GDP forecast). *Domestic tax revenue* is to grow by about 8 percent assuming that improvements in tax administration will account for about half of this growth. *Clearance revenue* is to grow by about 7 percent—3 percentage points above nominal GDP growth, reflecting improved cooperation with Israel on clearance revenue collections and the impact of higher imports to Gaza via Israeli official channels after the closure of the tunnels. *Nontax revenue* is to grow at 8 percent on account of nominal GDP growth and increased transfers from the Palestinian Investment Fund.
- *Fuel subsidy* ('fuel tax refund') is budgeted to decline by 0.7 percentage points of GDP.
- *Recurrent spending* is budgeted to rise by 4.4 percent, remaining stable in terms of GDP against the reduction in 2013. The wage bill is projected to increase by almost 5 percent to factor in a 1.25 percent annual increase under the Civil Service Law, a 2.5 percent COLA increase, commitments from the previous government to the unions regarding wage increases to teachers and health workers, and promotions in the security agencies. Savings for the wage bill are expected to be generated by reductions in supervisory and transportation allowances, and a zero net hiring restriction is imposed. *Transfers and use of goods and services* are to increase by 9.8 and 6.7 percent, respectively. This is, however, inconsistent with the statement on the budget by the Ministry of Finance, suggesting that increases for transfers and operational spending are to be limited to growth in inflation, and might in turn reflect the fact that the budget was based on 2013 preliminary data that overestimated budget implementation for transfers and the use goods and services. *Net lending* is projected to decline by about 20 percent, reflecting determination by the Ministry of Finance to improve debt collections on the basis of better and regular information from Israel about non-payers for communal services. To that end, a committee in the Ministry was set up to study the issue of net lending.
- *Development spending* is to almost double, with donors assumed to provide 86 percent of the total allocation.
- *An overall balance* (commitment basis) is estimated at about 13.7 percent (on IMF GDP forecast), that is only 0.2 percentage points lower than in 2013, with zero financing gap.
- *Overall donor support* is assumed to increase by 19 percent to \$1.6 billion to fully cover the deficit.

22. Staff urged the authorities to put in place measures that close the financing gap, to avoid accumulation of arrears and to contain fiscal risks. The authorities should go further in containing the deficit, including by resisting unaffordable spending demands from unions. If not, accumulation of arrears will continue, thereby hurting the private sector and undermining the credibility of the PA. In addition, competition for donor aid is especially fierce given the situation in Syria and elsewhere in the region, implying that external budget support could potentially fall short. Staff therefore recommends a package of additional measures, mainly on the expenditure side, to cover the financing gap:

Fiscal Measures in 2014

Measure	NIS Million	USD Million	Percent of Budget	Percent of GDP
Identified financing gap in 2014	986	277	...	2.3
Total proposed measures	986	277	...	2.3
Elimination of fuel tax subsidy	441	124	100	1.0
Wage bill	199	56	2.7	0.5
Rationalization of transfers	346	97	6.0	0.8

- Containing the overall increase in the wage bill to 2 percent, the same as last year. This can be achieved through a combination of: (i) applying the net hiring freeze to the West Bank and reducing the headcount as planned in Gaza; (ii) limiting the COLA; and (iii) a further rationalization of selected allowances for public sector workers, especially those going to high income earners;

- Accelerating the reduction of poorly targeted fuel subsidies, especially given lower international oil prices, while expanding the targeted cash transfer mechanism to support the poor (Box 3);

- Limiting the increase in transfers and use of goods and services to 2 percent, in line with inflation, while allowing for an expansion of targeted social assistance programs. This can be achieved by an expansion of means testing to benefit recipients outside the cash transfer program.

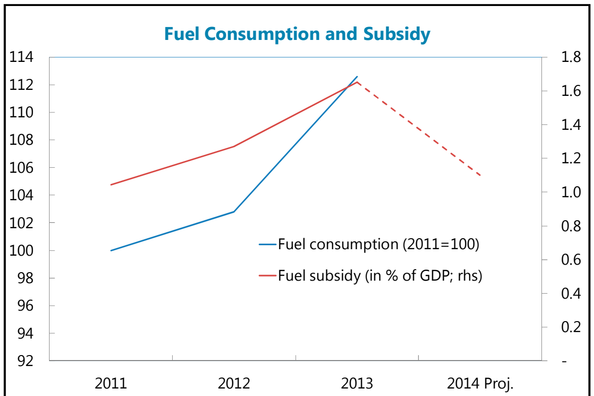
It is important to note that staff recommended these measures more than four months ago, and they were aimed at closing the financing gap when implemented in full over one year. Now, however, the year is nearly half over, and the fiscal effort to close the gap will have to be proportionately greater. At the same time, fiscal risks have increased further, necessitating the development of a contingency plan that would address the added uncertainty.

23. The authorities and staff agreed on the need to improve revenue collection. By the authorities' own account, tax compliance is low, and tax exemptions are excessive. It is estimated that less than 30 percent of taxpayers pay local taxes, and significant gains could be made by improving compliance. The new revenue strategy goes some way towards strengthening revenues by broadening the tax base and raising compliance, although the results may be slow to materialize (Box 4). Staff recommends that efforts focus on strengthening the Large Taxpayer Unit (LTU), including by expanding the number of large taxpayers, collecting back taxes, and generally improving enforcement (for instance, by fully applying existing penalties for noncompliance). Additionally, while the proposed

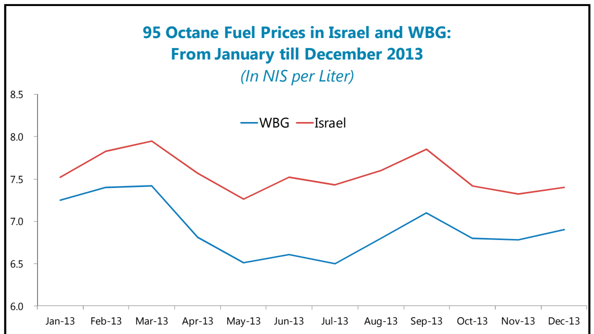
amendments to the Investment Promotion Law are welcome and should be introduced without delay, tax exemptions could be further scaled back, in line with the IMF technical assistance recommendations.[19] Staff does not see much room for reductions in income taxes proposed in the revenue strategy.

Box 3. Fuel Subsidies

The PA exercises monopoly power over fuel imports via the General Petroleum Corporation (GPC) whose operations it heavily subsidizes. The subsidy covers losses of the GPC which arise when it purchases fuel products in Israel at market prices, and sells them at sub-market prices in the WBG.



Sources: Ministry of Finance; and IMF staff projections.



1/ All prices are at pump and include VAT. PA prices include 16 percent VAT and Israeli prices include 17 percent VAT that changed to 18 percent in June 2013. (Eilat has 95 fuel priced differently than the rest of Israel)

Sources: Ministry of Finance - West Bank and Gaza, Ministry of National Infrastructures ,Energy and Water Resources - Israel.

The size of the subsidy is determined by the Ministry of Finance, which sets up a sale price for each type of fuel in consultation with the head of the revenue council at the Ministry of Finance and the head of the GPC. This price and the volume of fuel consumption ultimately define operating losses of the GPC, covered later on by the budget via a "fuel tax refund". In case of a liquidity shortage, the GPC resorts to borrowing from domestic banks (total stock of NIS 878 million as of end-April 2014), or to using a credit line from the Israeli fuel suppliers. The latter amounts to NIS 700 million and is currently nearly exhausted.

While the subsidy started in 2003 with the objective of preventing fuel smuggling from Israel, it later grew in line with fuel consumption to become a broad-based social transfer. As of 2013, its size reached 1.7 percent of GDP. As mentioned in Box 2, the 2014 budget aims at scaling back the fuel subsidy to the level of 2011.

[19] See the September 2013 IMF Staff Report for further details on these recommendations.

Box 4. Revenue Strategy

As part of a general effort to improve revenue, in early 2014 the government developed a comprehensive strategy for reforms of tax policy and tax administration that is tailored to the circumstances of the WBG and incorporate recommendations from international experts. The strategy aims to:

- Expand the tax base and increase the number of taxpayers;
- Increase compliance by registered taxpayers;
- Review existing tax exemptions, including those provided in the Investment Encouragement Law;
- Improve trade and fiscal relations with the Israeli side through specialized primary working committees and subcommittees tasked with resolving outstanding issues and improving collection through clearance.

Specific tax administration measures proposed under the strategy for 2014–15 involve strengthening the LTU, registering unregistered tax payers, resolving outstanding customs and tax disputes, imposing penalties and fines for noncompliance, and combating the under-pricing of imports. On tax policy, the authorities intend to limit tax incentives, introduce a new tax on dividends, and lower corporate and personal income taxes with the view to improve tax compliance.

As of end-May, the Cabinet approved the following two revenue-increasing changes to the tax regime:

- Amend the investment promotion law to limit incentives to the first 7 years of life of an investment project as follows: for any investment project of more than $100,000 in value that employs at least five people to impose an income tax of 5 percent for the first 5 years, 10 percent for the following 2 years, and 15 percent thereafter. The measure is currently awaiting Presidential signature.
- Introduce a withholding tax of 10 percent on dividends.

By authorities' estimates, the tax on dividends—if implemented—is expected to bring an additional $20–30 million, while the reduction in tax incentives will probably have an effect over the medium term. Other changes include lowering corporate income tax on profits from bank's loans to SMEs from 20 to 10 percent to incentivize them to lend to SMEs, and to remove the tax on interest income from bank deposits. The revenue loss as a result of the last change is considered by the Ministry of Finance to be negligible.

24. The authorities agreed with staff's analysis, but were guarded about the proposed measures, citing the challenging political environment. Staff and the authorities shared a similar fiscal outlook for 2014, although the budget contains an optimistic assumption on donor financing. The authorities agreed in principle with staff's recommendation to run a prudent budget in these uncertain times, but cited pressures from unions as limiting the extent of fiscal consolidation. In particular, they recognized the need to contain wage increases, but stressed that they were bound by previous commitments to increase wages for certain workers, including teachers and security personnel. Staff stressed that this would contribute to a financing gap and possibly further build-up of arrears. With respect to transfers and spending on goods and services, the authorities indicated that they have room for adjustment, without committing to specific measures. They also expressed confidence in their ability to apply cash rationing and attract $1.3 billion in budget support (versus $1.2 billion of untied aid projected by staff) and sufficient development aid to avoid a further buildup of arrears.

B. Medium-Term Fiscal Policy

25. The sustainability of the PA's current fiscal financing model remains in doubt under the baseline assumption. As was discussed in detail in the September 2013 IMF staff report, this model relies on large deficits financed by donor aid, creating aid dependency and associated problems, including disincentives for mobilizing revenue and a slow and uneven expenditure consolidation. Aid flows have also been volatile, making fiscal planning difficult, and aid has been increasingly used to finance government consumption, rather than investment to expand the productive capacity of the economy and support private sector development. Furthermore, persistent aid shortfalls led to the accumulation of arrears to the private sector and excessive reliance on domestic bank borrowing, thereby raising financial system risks and potentially crowding out credit to the private sector.

26. A growth-friendly fiscal consolidation to reduce financing requirements and debt levels should be the anchor for medium-term fiscal policy. To ensure fiscal sustainability, the PA could aim to consistently deliver lower recurrent fiscal deficits. It should undertake a mix of growth-friendly spending and revenue measures anchored in a credible medium-term plan. On the spending side, reforming the generous pension system and the civil service, and containing health care costs (especially the referral process for treatment abroad) are priorities. Untargeted subsidies, such as the fuel subsidy, should be abolished and replaced by the well-targeted cash transfer system. That, in turn, might require additional resources. On the revenue side staff noted that efforts should focus on mobilizing domestic revenues, mainly through lower tax exemptions and enhanced compliance.

27. Reduction in recurrent deficits should free space for more growth-enhancing development spending. The PA, together with its development partners, could prepare a plan to reorient government spending toward investment and away from current spending, building on the World Bank's ongoing public expenditure review. In addition, the recently-finalized National Development Plan (NDP) 2014–16 provides a reform roadmap for the next three years and gives an indication of where infrastructure needs are greatest. With this analysis as background, donors could begin to redirect aid from budget support to support for projects that invest in infrastructure and education. Institutional reforms also need to be stepped up to support private-sector development.

28. The PA's efforts alone would not be sufficient to ensure fiscal sustainability in the medium term. It would be important for donors to support new comprehensive reforms that will help the PA transition to viable public finances with additional aid. The aid could be based on multiyear commitments and possibly be linked to PA deliverables, including progress on public financial management (PFM; Box 5). It would also be important that Israel lifts the restrictions that constrain private sector activity and ensures an uninterrupted transfer of clearance revenue.

Box 5. Summary of TA Recommendations on PFM

A public financial management reform framework was launched in 2009 and subsequently updated in 2011–13. The most recent IMF TA mission in January 2014 found that, despite the difficult political environment, the authorities achieved significant progress, particularly in the early years. However, much remains to be done, specifically in the following four main areas :

- The regulatory framework for PFM is still somewhat outdated and incomplete. *Recommendation*: prepare and formally approve a new Organic Budget Law, update Financial Regulations accordingly, and finalize related manuals and guidelines and formally approve them.
- The budget preparation process is weak and projections are not realistic, despite the fact that the 2014 budget was based for the first time on a medium-term fiscal framework developed in-house. *Recommendation*: improve realism of the projections for revenue and donor support, develop an appropriate budget ceilings methodology to ensure that the aggregate expenditure ceiling and the spending ministry ceilings used during budget preparation are consistent with a realistic estimate of revenues, integrate a fully-staffed macro-fiscal unit within the Ministry of Finance in the Budget Department, sequence resources more acutely in transitioning to program budgeting, and develop procedures and skills in capital budgeting and capital project management.
- Commitment control and cash management need to be improved. The Financial Management Information System (FMIS), while a major achievement, is not fully utilized for the purposes of expenditure controls, especially with regard to commitments and arrears, and monthly fiscal reporting still remains manual. *Recommendation*: approve the necessary FMIS system configurations for commitment controls and arrears monitoring, finalize the legal and regulatory backing necessary for commitment controls and arrears monitoring, improve cash planning and cash forecasting, make the cash management committee operational, integrate commitment control and cash management, review and update the Accounting Manuals and increase accounting skills within the Ministry of Finance and across ministries, and identify the causes of in-year fiscal reporting errors and take permanent remedial actions.
- Financial reporting is weak. The latest available audited accounts are for 2010, and the financial statements for 2011 have not yet been submitted to the State Audit and Administrative Control Bureau. *Recommendation:* improve accounting skills within the Ministry of Finance and across ministries, implement cash-basis International Public Sector Accounting Standards (IPSAS) mandatory requirements in the 2011 financial statements, identify the 'encouraged' disclosure requirements of the cash-basis IPSAS, prepare a gap analysis and a plan to capture the data and disclose them from the 2013 financial statements, clear the backlog of outstanding financial statements (2011, 2012, and 2013), and institute an annual financial reporting cycle.

29. **The authorities and other interlocutors concurred with staff's analysis and recommendations, but the degree of traction remains uncertain given the difficult political environment**. The authorities were concerned that the proposed fiscal measures, particularly on the expenditure side, are politically difficult, and argued that continuous donor support will be needed in lieu of rigorous policy action, absent progress on the peace front. Indeed, the prevailing view was that, as long as Israeli restrictions remain in place, the public sector would have to be the economy's engine. Donors cited fiscal pressures at home and competing demands for aid (such as Egypt and Syria) as important constraints on stepped-up aid to the PA, even though they pledged stronger financial support should the peace process resume and succeed. The Israeli officials did not commit to further easing of restrictions. They stressed their efforts at good on-the-ground cooperation, including regular

meetings between the Palestinian and Israeli ministries of finance since June 2013 which had produced a more consistent flow of clearance revenue. However, these improvements in cooperation are now under pressure as a result of the Israeli rejection of the new Palestinian consensus government.

C. Financial Sector

30. Staff discussed recent trends in financial stability with the PMA and commercial banks. Staff noted that the banking sector was performing well. However, concerns were expressed in two areas: the ongoing risks stemming from the banks' exposure to the PA and its employees, although this exposure had fallen recently; and the growing exposure of the banking system to the construction and real estate markets. Meanwhile, the PMA continued to extend its mandate to supervise Jordanian branches and subsidiaries, reducing the risk of spillovers from Jordan.

31. Staff urged the PMA to continue to monitor banks' exposure to the PA closely. Private banks and the PMA shared staff's concerns about banks' high exposure to the PA. It was agreed that increasing indebtedness and a deteriorating fiscal position of the PA could threaten the health of the banking system. Private banks stated that severe payment delays by the PA or defaults may cause a disruption of banking activities and lead to financial instability. In response, the PMA noted that the PA's outstanding debt to banks in relation to total credit facilities had declined from 33.4 percent at end end-2012 to 30.6 percent at end-2013 and indicated that it continues to carefully monitor risks through quarterly stress tests. It also noted the positive role that the issuance of government bonds could play for financial stability, and views securitization of government debt as an important step in support of banks' liquidity management and, ultimately, towards developing a domestic debt market.

32. Staff flagged potential risks stemming from banks' exposure to housing and consumer loans. Real estate loans account for 21 percent of banks' private sector loan portfolios and for more than 20 percent of NPLs. At the same time, the share of consumer loans has increased rapidly from 17 to 29 percent since 2011. Together, real estate and consumer loans account for 50 percent of all private credit. A continued growth slowdown and rising unemployment could lead to an increase in NPLs, putting pressure on banks' balance sheets. To address these risks, staff recommended to improve data on the real estate and consumer market and to step up stress testing of banks' resilience to housing price shocks. Stricter macro-prudential measures (e.g., with respect to loan-to-value and debt-to-income ratios) are advisable, especially if housing prices were to increase.[20] In this context, staff also welcomed banks' intention, expressed during the meeting with banks' representatives, to shift their loan portfolios away from housing and consumer markets to SMEs. This effort will be facilitated by the expansion, currently under way, of the recently established credit registry to SMEs.

[20] Data on real estate prices, rents and overdue loans are not available, currently making close monitoring of real estate market developments difficult.

D. Structural Issues

33. **Without a comprehensive removal of Israeli restrictions it will not be possible to set the economy on a significantly higher growth path.** The restrictions place a binding constraint on private sector production and investment, and should be removed. This includes the removal of restrictions on the movement of people and goods, enabling trade between the West Bank and Gaza, and access to Area C and East Jerusalem, including the right for the PA to issue construction permits and to develop its land and water resources. A recent report by the World Bank assessed the potential for growth associated with the removal of the restrictions related to Area C to be equivalent to 35 percent of GDP.[21]

34. **At the same time, there is much the PA can do—even under the political status quo—to deepen and broaden the private sector's footprint in the economy.** Primarily, this involves measures to strengthen the business climate and reduce the cost of doing business.[22] The PA has made some progress implementing reforms to reduce the cost and complexity of business registration, and recently promulgated the Leasing Law to facilitate access to finance.[23] However, an incomplete competition framework and missing regulatory bodies, despite significant progress over the past years in overall institution building, prevent equal opportunities for insiders and outsiders, and the legal framework is not business-friendly. The PA could take measures to reduce costs where possible, simplify burdensome procedures, and update, clarify and harmonize the economic legislation. Enactment of the New Companies Law, the New Industry Law, the Debt Resolution Law, the Secured Transactions Law, and activation of the Movable Assets Registry are important to ensure a level playing field in the legal treatment of public and private companies, and to facilitate access to bank finance by enabling the use of movable assets as collateral.

35. **Structural reforms are also necessary to prepare the economy for a possible scaling up of investment in case there is progress in the peace talks.** The measures outlined above to strengthen the business climate should be reinforced by actions to further build capacity to effectively absorb scaled up donor aid in case of a breakthrough in the peace process. Public investment management procedures and capabilities need to be further enhanced. The Ministry of Planning and Administrative Development has no central appraisal function, and portfolio management is weak. The recent World Bank Public Expenditure and Financial Accountability (PEFA) assessment ranks the PA poorly on indicators related to appraisal, costing, prioritizing, selecting, monitoring of implementation of projects, and management of public investment within a multi-year framework.[24] The WBG also scores poorly on the IMF's Public Investment Management

---

[21] For details see *Area C and the Future of the Palestinian Economy*, the World Bank, 2013.

[22] For details see the IMF report for the AHLC of September 2013, Selected Issues Chapter, "Growth in the Palestinian Economy," available at http://www.imf.org/external/country/wbg/rr/index.htm.

[23] The new Financial Leasing Law was signed by the President in February 2014.

[24] World Bank, "West Bank and Gaza: Public Expenditure and Financial Accountability (PEFA); Public Financial Management Performance Report," No. AUS3141, Washington, DC, June 2013.

Index.[25] These issues need to be addressed to avoid cost overruns and to plan and provision for the downstream recurrent expenditures of completed projects. The introduction of a new procurement system in 2014 is encouraging in this regard, but full implementation is awaiting the actions of the Public Procurement Agency.

36. The authorities noted that their vision for economic reform in the next three years is outlined in the new NDP 2014–16 (Box 6)**.** They reiterated their commitment to institutional and structural reforms to unleash the potential for private sector growth and for more effective use of scaled-up aid. They noted, however, that the policy agenda will be contingent on the outcome of the peace process and availability of donor aid. Staff agreed that when coupled with fundamental reforms and relaxation of Israeli restrictions the NDP could constitute a blueprint for economic development in the WBG over the next few years, but emphasized the need to preserve macroeconomic stability and pursue medium-term fiscal adjustment to free fiscal space for growth-enhancing spending.

[25] Dabla-Norris and others (see IMF 2011 Working Paper "Investing in Public Investment: An Index of Public Investment Efficiency") introduce a Public Investment Management Index (PIMI) which ranks countries based on four different stages of public investment management: project appraisal, selection, implementation and evaluation. The WBG ranks 67th out of 71 countries, with a PIMI score of 0.80 against a sample average of 1.68.

Box 6. Palestinian National Development Plan 2014–16

The NDP is a strategic policy framework for social and economic development. It aims to revitalize the Palestinian economy, build and expand state institutions, and improve the quality of life of Palestinians. It is based on program budgets and designed to enhance the integration of national planning and budgeting. The NDP includes an elaborate monitoring framework and performance indicators to assess implementation. It recognizes the formidable challenges facing economic and social development in the WBG. These include (i) the multitude of Israeli restrictions, (ii) the administrative and political split between the West Bank and Gaza, and (iii) the current poor economic and fiscal conditions.

The NDP builds on previous development plans in four key sectors. These sectors and selected key objectives are:

i. *Economic development and employment*. Objectives include promoting investment (especially for SMEs), encouraging public-private partnerships, upgrading laws and regulations to improve the business climate, and improving competitiveness.

ii. *Governance and institution building*. Objectives include upgrading and reforming public financial management systems (consolidation of tax departments, building tax collection capacity, and using computerized information systems), streamlining public expenditure, ensuring effective monetary management, and further improving service delivery.

iii. *Social protection*. Objectives include expanding high-quality social protection systems, improving services for (former) prisoners, and expanding and improving education and healthcare.

iv. *Infrastructure*. Objectives include upgrading roads and telecom systems, diversifying energy sources, rationalize energy consumption, ensuring efficiency of water use.

The NDP's envisaged investments are based on a macro-fiscal framework that includes an optimistic scenario in addition to the baseline. Over a three-year period, the NDP's expenditure plans add up to US$539 million, of which US$281 million is for investments, the remainder for operational spending. The baseline scenario assumes political and economic status quo, with growth decelerating to 1 percent in the medium term. To avoid arrears and bank financing, external budget support would increase to US$1.5 billion. The optimistic scenario assumes a breakthrough in the peace negotiations with subsequent relaxation of Israeli restrictions and a sharp increase in foreign and domestic investment. In the medium term, growth would accelerate to double digits and external budget support would decrease to US$0.9 billion.

STAFF APPRAISAL

37. The Palestinian economy operates in an environment of heightened political uncertainty. The suspension of peace talks and uncertain prospects for their resumption elevate risks to the economy and shorten planning horizons for both policy makers and private sector decision makers. The Fatah-Hamas reconciliation also adds an element of uncertainty, as Israel has indicated its preparedness to take measures against the PA. This uncertainty is further heightened by the recent increase in political tensions following the abduction of three Israeli youths in the West Bank.

38. The high degree of political uncertainty implies a wide range of possible economic outcomes. A resumption and successful conclusion of the peace talks would strengthen confidence, boost investment, and open the door for donor initiatives and the Initiative for the Palestinian Economy led by the Office of the Quartet Representative that could transform the economy. In contrast, a clear failure of the peace talks with no prospect of resumption would lead the economy down a path marked by much weaker, perhaps even negative, economic growth and rising unemployment, potentially creating the conditions for social unrest. The political status quo—where the political conflict remains unresolved but the resumption of peace talks remains a possibility—could quickly become unsustainable over the medium term if the fiscal financing model remains the same and economic reforms are limited, as this would result in economic stagnation, rising unemployment, and a gradual erosion in living standards. A shift to a more sustainable financing model, with more predictable aid flows financing more growth-friendly government spending, and some economic reforms along with easing of Israeli restrictions, could produce better and more sustainable economic outcomes over the medium term, even in a political status quo scenario.

39. Economic developments and prospects are marked by slowing growth and fiscal strains, despite sustained donor assistance. Weighed down by weak private demand, fiscal retrenchment, and broadly unchanged Israeli restrictions, growth continued to decline in 2013, and unemployment rose. For 2014, staff projects roughly unchanged growth at close to 2 percent, and a continued rise in the unemployment rate. Inflation is projected to remain benign at a small margin above Israeli inflation. Main near-term risks to the outlook relate to fiscal fragility, including a potential shortfall in donor aid, inability of the PA to restrain spending, and reductions, including politically motivated ones, in clearance revenue transfers.

40. Careful fiscal management is required in these uncertain times. For 2014, staff's baseline projection is for a financing gap of nearly \$300 million, about 2½ percent of GDP. Absent further adjustment or additional donor support, the gap would likely be covered by further arrears accumulation at the expense of private sector liquidity and domestic bank borrowing at the expense of financial stability. Given this gap, and recently increased fiscal risks, the PA should limit the increase in the overall wage bill to 2 percent, rather than the budgeted 5 percent. This could be achieved by freezing wages and promotions, further rationalizing allowances, and further tightening the policy of zero net-hiring by applying it to West Bank and

Gaza payrolls individually. Moreover, fuel subsidies could be abolished, and transfers to recipients outside the cash transfer system rationalized. In parallel, the targeted cash transfer system should be expanded. Growth in contingent liabilities of the PA associated with net lending should also be arrested, and the Ministry of Finance should intensify efforts to collect debts from municipalities for communal services. On the revenue side, efforts need to continue to strengthen the large taxpayer unit, collect back taxes, and improve enforcement. Tax exemptions should be scaled back, in line with the IMF technical assistance recommendations, and recent steps by the authorities to this end are welcome. Moreover, given rising fiscal risks, the authorities should prepare a contingency plan containing implementable measures should the risks materialize.

41. In the medium term, the authorities need to safeguard fiscal sustainability. Under the baseline projections, assuming steady financing sources, substantial financing gaps remain as a result of large financing requirements. With negative shocks, to which the WBG is highly vulnerable, debt would become unsustainable. In addition, public spending is tilted towards wages, pensions, and transfers, rather than towards much needed investment in public infrastructure, leaving in place obstacles to private sector development. This would lead to disappointing growth and employment outcomes, threatening social stability. As stressed in the September 2013 staff report, the PA should reduce financing needs and gradually redirect its spending from consumption to investment. In the medium term, the focus should be on reducing the wage bill (including by undertaking a full-scale civil service reform), and reforming the pension and healthcare (referrals) systems. The cash transfer system to protect the most vulnerable should be expanded as a compensatory measure. Public financial management needs to be further strengthened in line with recent TA recommendations. On the revenue side, efforts should focus on improving compliance and reducing exemptions.

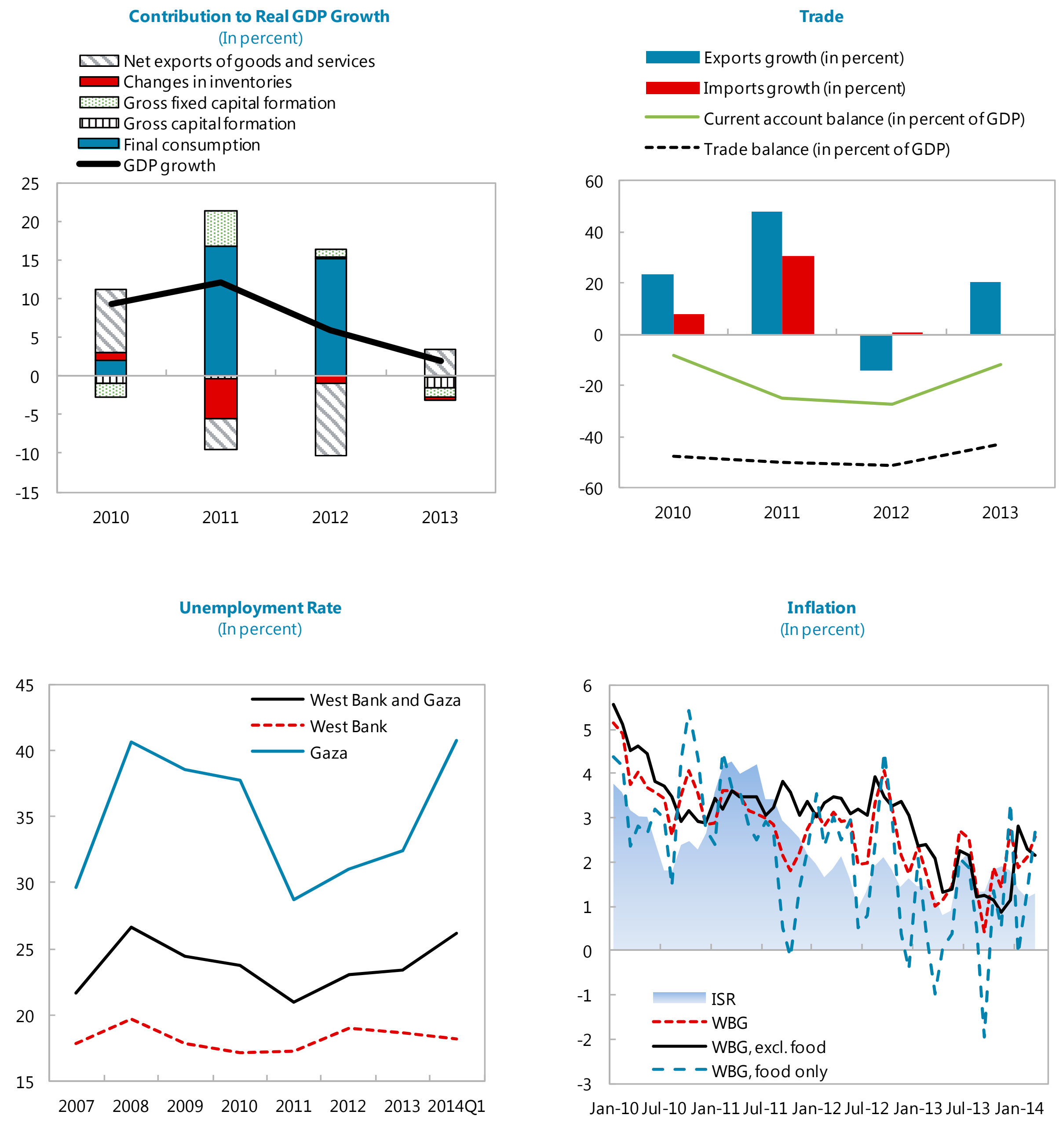
42. While the authorities should do their part to ensure macro-fiscal stability, additional donor support and relaxation of Israeli restrictions are needed. A prerequisite for a dynamic Palestinian private sector is the removal of Israeli restrictions. This would buttress the PA's efforts at growth-friendly fiscal consolidation. At the same time, continuous and predictable donor support will be necessary in the transition to a more sustainable financing model and a gradual reduction in the public sector's economic footprint.

43. The banking sector is healthy, but exposure to the PA poses risks. Banking indicators are strong, but stress tests point to vulnerability related to the exposure of the banking sector to the PA and its employees. To address this vulnerability, the PMA should support measures to diversify banks' lending portfolios towards SMEs. In particular, the PMA could further support development of the credit registry, strengthening laws and procedures guiding collateral, and increase banks' capital requirements on lending to the PA. PMA vigilance to the rapid growth in consumer loans and bank exposures to the real estate market is also needed.

44. Regardless of how the political process evolves, accelerated structural reforms are needed to improve growth prospects. Successful peace negotiations would likely lead to an easing of Israeli restrictions and scaled up foreign investment and aid. In such a scenario, further

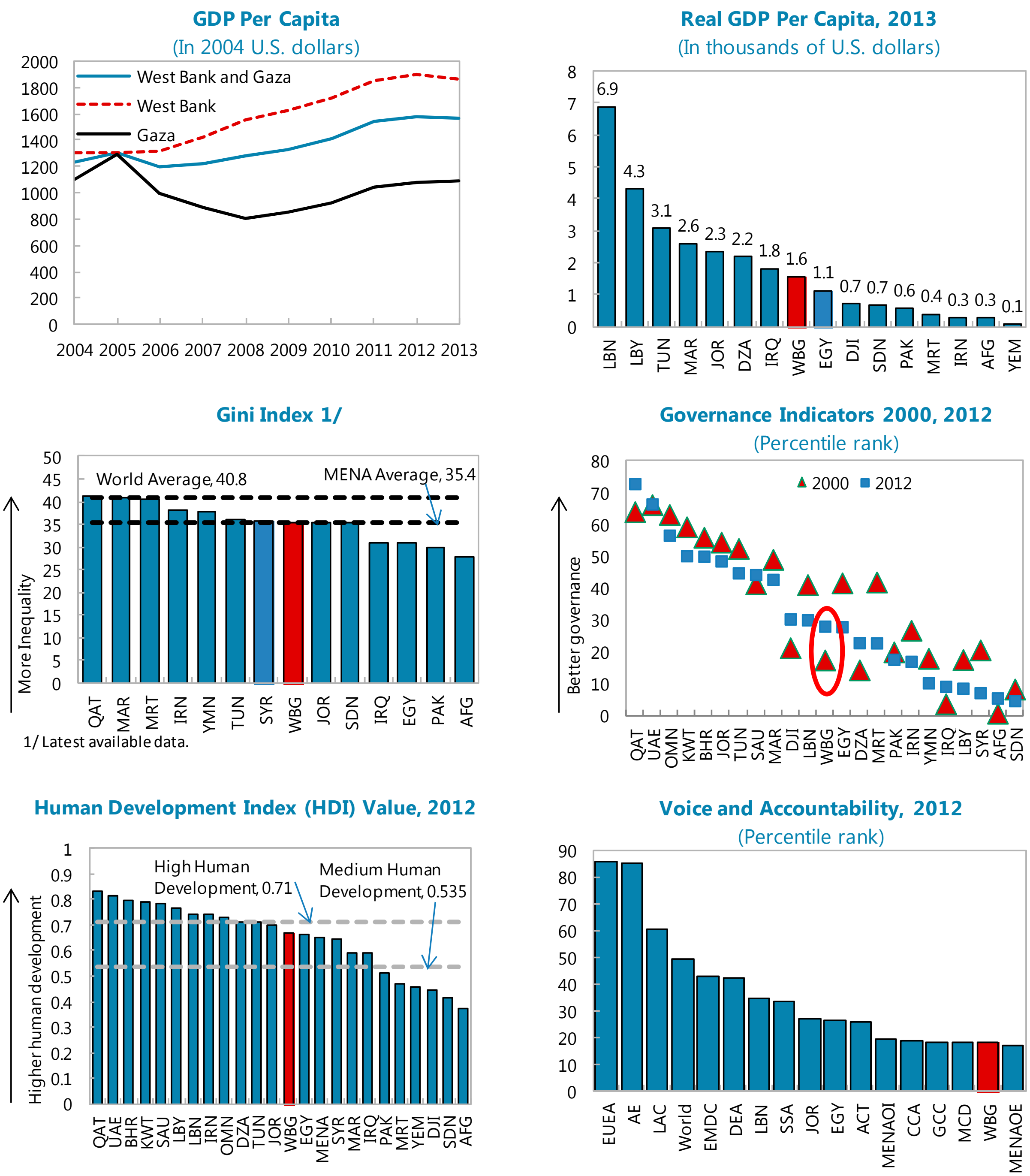
institutional and structural reforms—for instance, in the areas of public investment management and energy, water, land management reforms—are needed to strengthen the economy's absorptive capacity to fully realize the potential of the investment stimulus under the IPE. Under the baseline scenario, or if the peace process fails, structural reforms are all the more needed to strengthen the private sector, with measures to improve the business climate being particularly important. The authorities' own National Development Plan 2014–16 is a timely outline of a development strategy for the next few years. Its focus on the four key areas—business climate, institutional development, infrastructure, and social protection—is appropriate, but its implementation will need to take into account the PA's limited fiscal space and the need to maintain macroeconomic stability.

Figure 1. West Bank and Gaza: Recent Economic Developments, 2010–14



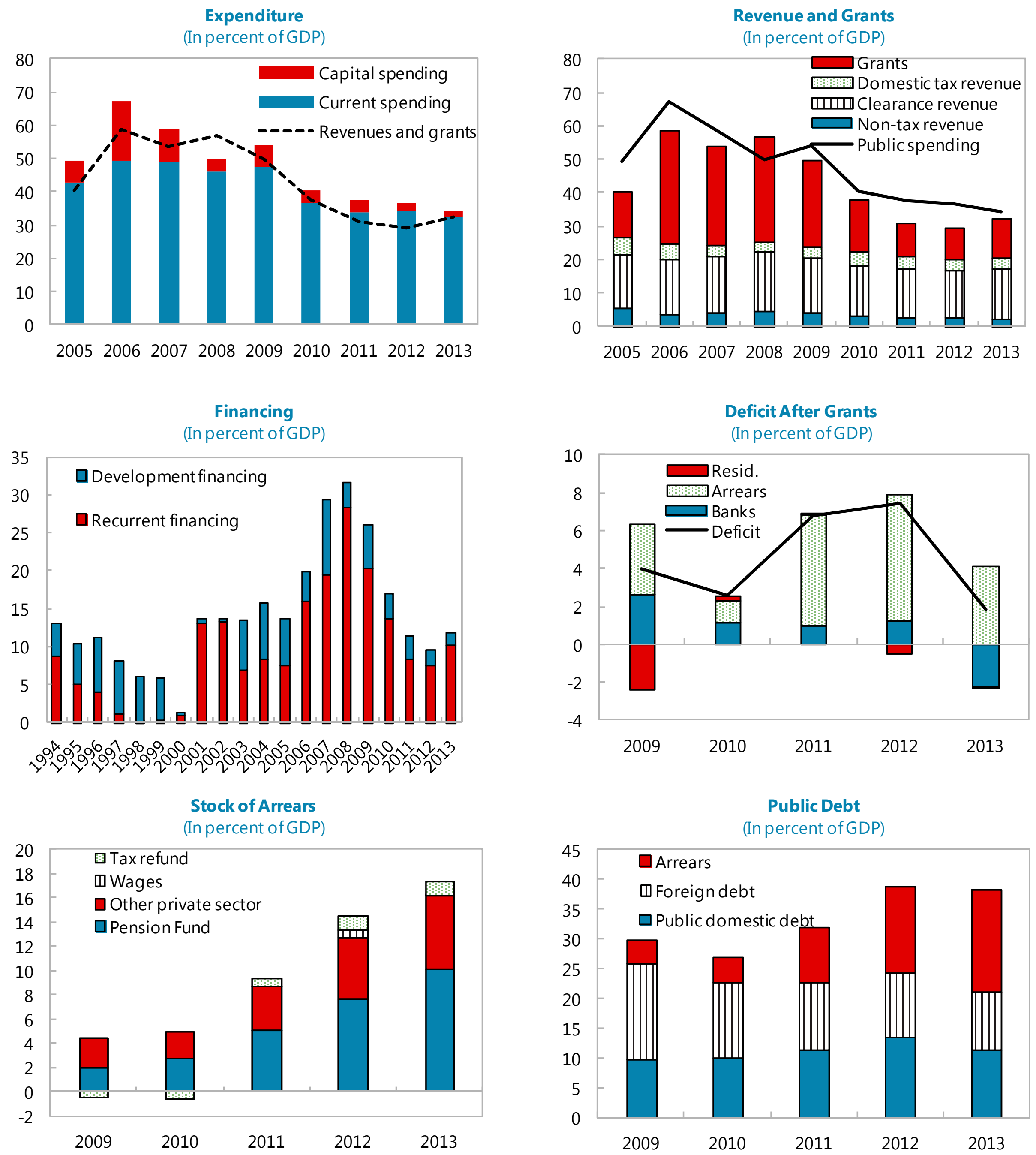
Sources: Palestinian Central Bureau of Statistics; and IMF staff estimates.

Figure 2. West Bank and Gaza: Social and Governance Indicators



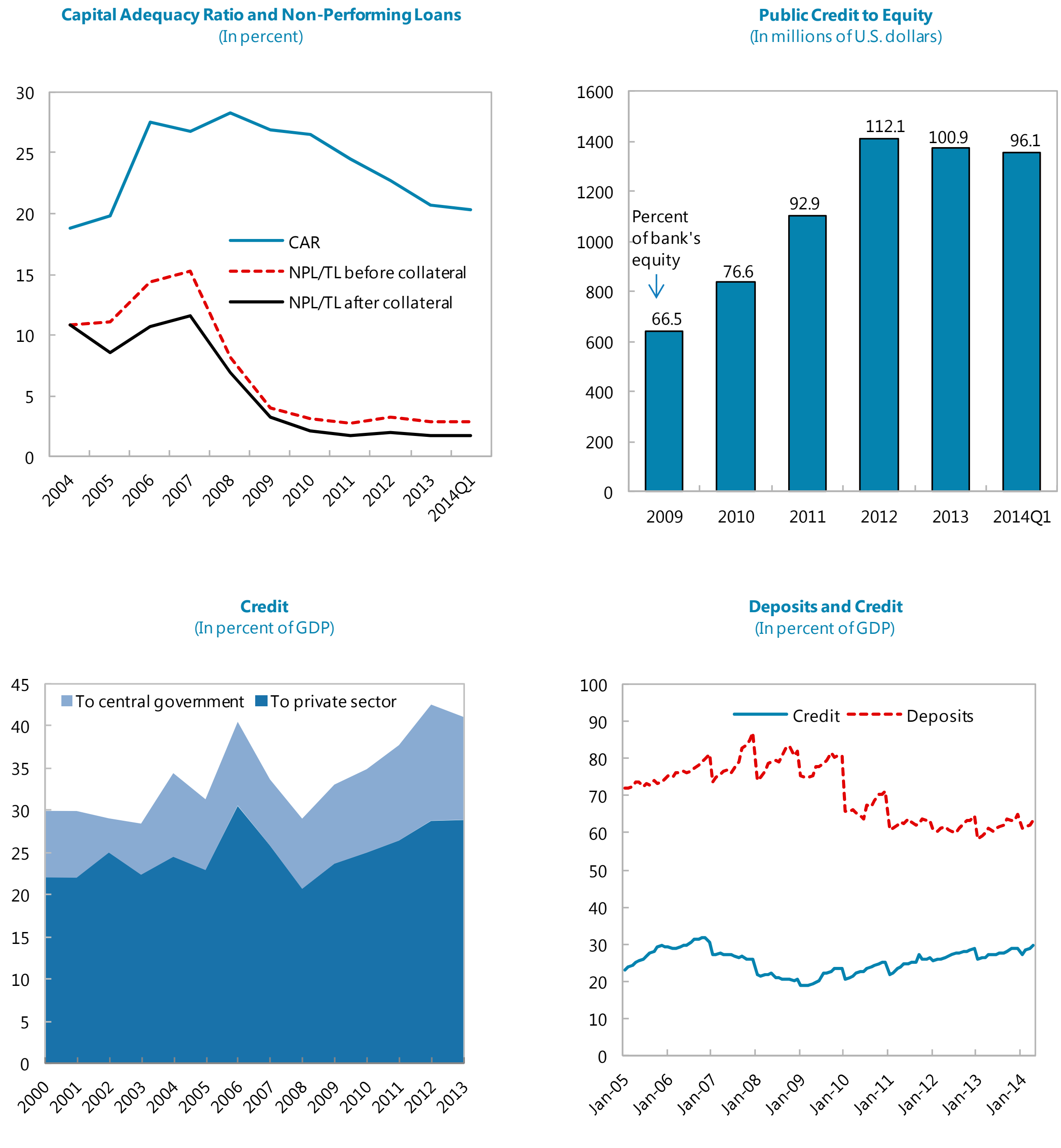
Sources: Palestinian Central Bureau of Statistics (PCBS); Regional Economic Outlook; World Bank World Development Indicators and Worldwide Governance Indicators; United Nations Development Programme (UNDP) Human Development Report 2012; and IMF staff estimates.

Figure 3. West Bank and Gaza: Fiscal Sector Indicators, 1994–2013



Source: Ministry of Finance.

Figure 4. West Bank and Gaza: Financial Sector Indicators, 2010–14



Sources: Palestine Monetary Authority; and IMF staff estimates.

Table 1. West Bank and Gaza: Selected Economic Indicators, 2011–19

	2011	2012	Est. 2013	Projections 2014	2015	2016	2017	2018	2019
Output and prices				(Annual percentage change)					
Real GDP (2004 market prices)	12.2	5.9	1.8	2.0	2.5	3.0	3.0	3.0	3.0
West Bank	10.4	5.6	0.9	1.6	2.0	2.7	2.7	2.6	2.7
Gaza	17.6	6.6	4.6	3.0	4.0	4.0	4.0	4.0	4.0
CPI inflation rate (end-of-period)	3.0	1.8	1.9	2.2	2.5	2.6	2.6	2.6	2.6
CPI inflation rate (period average)	2.9	2.8	1.7	2.1	2.4	2.6	2.6	2.6	2.6
Investment and saving				(In percent of GDP)					
Gross capital formation, *of which:*	17.3	13.7	12.6	11.9	11.9	11.4	11.0	10.8	10.7
Public	3.8	3.8	3.6	3.6	3.6	3.6	3.6	3.5	3.5
Private	13.5	9.9	8.9	8.4	8.3	7.8	7.4	7.3	7.2
Gross national savings, *of which:*	-6.4	-15.2	-5.4	-8.8	-10.6	-11.2	-12.1	-12.9	-13.7
Public	-4.7	-6.6	-1.1	-1.7	-2.3	-1.4	-0.6	0.1	0.8
Private	-1.6	-8.6	-4.3	-7.1	-8.3	-9.8	-11.5	-13.0	-14.5
Saving-investment balance	-23.6	-28.9	-18.0	-20.8	-22.5	-22.6	-23.1	-23.8	-24.4
Public finances 1/				(In percent of GDP)					
Revenues	20.9	20.2	20.4	21.6	21.9	22.2	22.5	22.7	22.9
Recurrent expenditures and net lending	34.0	34.4	32.6	33.2	32.1	31.0	30.0	29.1	28.3
Wage expenditures	18.2	17.2	17.0	17.0	16.6	16.1	15.6	15.1	14.6
Nonwage expenditures	14.3	14.4	13.8	14.2	14.0	13.8	13.5	13.2	13.0
Net lending	1.4	2.7	1.9	2.0	1.4	1.2	1.0	0.8	0.7
Recurrent balance (commitment, before external support)	-13.1	-14.2	-12.2	-11.6	-10.2	-8.8	-7.6	-6.5	-5.4
Recurrent balance (cash, before external support)	-8.0	-7.8	-8.3	-12.5	-11.0	-9.5	-8.3	-7.1	-6.0
Development expenditures	3.8	2.4	1.6	1.6	2.4	2.4	2.4	2.4	2.4
(In millions of U.S. dollars)	370	243	187	198	305	325	345	366	389
Overall balance (commitment, before external support)	-16.9	-16.5	-13.9	-13.3	-12.6	-11.2	-10.0	-8.9	-7.8
Total external support, including for development expenditures	10.1	9.1	12.0	10.9	9.5	9.0	8.6	8.2	7.8
(In millions of U.S. dollars)	984	930	1,362	1,309	1,205	1,218	1,231	1,245	1,259
External support for recurrent expenditure (in millions of U.S. dollars)	815	774	1,255	1,189	1,000	1,000	1,000	1,000	1,000
Financing gap (in millions of U.S. dollars) 2/	...	...	...	277	375	275	180	85	0
In percent of GDP	...	...	...	2.3	2.9	2.0	1.3	0.6	0.0
Monetary sector 3/				(Annual percentage change)					
Credit to the private sector	24.2	14.3	11.0	11.0	10.0	9.5	9.5	9.0	9.0
Private sector deposits	4.0	6.8	10.7	9.9	7.4	6.3	6.2	6.1	6.0
External sector				(In percent of GDP)					
Current account balance (excluding official transfers)	-32.0	-36.4	-29.1	-30.7	-30.4	-30.0	-30.1	-30.3	-30.6
Current account balance (including official transfers)	-23.6	-28.9	-18.0	-20.8	-22.5	-22.6	-23.1	-23.8	-24.4
Exports of goods and nonfactor services	15.4	16.3	18.6	18.6	18.5	18.4	18.3	18.2	18.1
Import of goods and nonfactor services	59.1	63.1	58.7	60.4	59.8	59.0	58.7	58.6	58.5
Net factor income	7.3	7.0	7.1	7.1	7.1	7.1	7.0	6.9	6.8
Net current transfers	12.7	10.9	15.0	13.9	11.7	11.0	10.3	9.7	9.2
Private transfers	4.4	3.3	3.9	4.0	3.8	3.6	3.4	3.2	3.0
Official transfers	8.3	7.6	11.1	9.9	7.9	7.4	7.0	6.6	6.2
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	9,775	10,255	11,317	12,004	12,726	13,539	14,386	15,266	16,198
Per capita nominal GDP (U.S. dollars)	2,345	2,389	2,560	2,638	2,718	2,811	2,904	2,996	3,092
Unemployment rate	21	23	25	27	29	30	31	32	33
Al Quds stock market index (annual percentage change)	-2.6	0.1	13.4	…	…	…	…	…	…

Sources: Palestinian authorities; and IMF staff estimates and projections.

1/ Commitment basis.

2/ Financing gaps in the medium-term are expected to be filled by grants that are yet to be identified.

3/ End-of-period; in U.S. dollar terms.

Table 2. West Bank and Gaza: Central Government Fiscal Operations, 2011–17

	2011	2012	2013		Budget	Projections			
			Sep. Staff Report	Outcome	2014	2014	2015	2016	2017
	(In millions of shekels, unless otherwise stated)								
Net revenues	7,321	7,989	8,085	8,348	9,311	9,216	9,835	10,568	11,342
Gross domestic revenues	2,642	2,806	3,047	3,078	3,326	3,231	3,414	3,622	3,840
Tax revenues	1,727	1,852	2,129	2,157	2,329	2,240	2,339	2,463	2,595
Nontax revenues (accrued)	915	954	918	921	997	991	1,076	1,160	1,245
o/w arrears	130	59	---	---	---	---	---	---	---
Clearance revenues (accrued)	5,095	5,617	5,870	6,103	6,545	6,545	6,880	7,306	7,762
o/w arrears	-235	-479	-147	14	---	---	---	---	---
Less tax refunds 1/	416	434	832	834	560	560	460	360	260
o/w arrears	368	239	---	27	---	---	---	---	---
Recurrent expenditures and net lending (commitment)	11,897	13,593	13,431	13,336	13,915	14,175	14,401	14,744	15,155
o/w arrears	1,300	1,863	-272	1,601	---	-356	-353	-351	-351
Wage expenditures (commitment)	6,381	6,812	6,956	6,928	7,265	7,265	7,458	7,649	7,849
o/w arrears	374	816	-272	380	---	---	---	---	---
Nonwage expenditures (commitment)	5,015	5,709	5,925	5,648	6,050	6,050	6,292	6,544	6,806
o/w arrears	926	1,046	---	1,221	---	-356	-353	-351	-351
Net lending (commitment)	501	1,072	550	760	600	860	650	550	500
o/w arrears	---	---	---	---	---	---	---	---	---
Development expenditures (commitment)	1,325	937	1,010	674	1,260	704	1,077	1,142	1,211
o/w arrears	270	124	---	66	---	---	---	---	---
Recurrent balance (commitment, excl. development expenditure)	-4,576	-5,604	-5,346	-4,988	-4,604	-4,959	-4,566	-4,175	-3,814
Overall balance (committment)	-5,901	-6,541	-6,356	-5,662	-5,864	-5,663	-5,643	-5,317	-5,024
Total financing	5,901	6,541	6,356	5,662	5,864	5,663	5,643	5,317	5,024
Net domestic bank financing	334	490	272	-895	---	425	425	425	425
External debt repayment						-48	---		
External financing for recurrent expenditures	2,915	2,986	4,319	4,532	4,784	4,226	3,528	3,514	3,507
External financing for development expenditures	605	601	676	383	1,080	429	722	765	811
Arrears	2,043	2,646	-125	1,680	---	-356	-353	-351	-351
Residual/Financing gap 2/	4	-182	1,214	-38	---	986	1,322	965	632
	(In millions of U.S. dollars, unless otherwise stated)								
Net revenues	2,046	2,072	2,153	2,312	2,586	2,592	2,788	3,008	3,234
Gross domestic revenues	738	728	811	853	924	909	968	1,031	1,095
Tax revenues	483	480	567	598	647	630	663	701	740
Nontax revenues (accrued)	256	248	244	255	277	279	305	330	355
o/w arrears	36	15	---	---	---	---	---	---	---
Clearance revenues (accrued)	1,424	1,457	1,563	1,691	1,818	1,841	1,950	2,079	2,213
o/w arrears	-66	-124	-39	4	---	---	---	---	---
Less tax refunds	116	113	221	231	156	158	130	102	74
o/w arrears	103	62	---	7	---	---	---	---	---
Recurrent expenditures and net lending (commitment)	3,325	3,525	3,576	3,694	3,865	3,987	4,082	4,196	4,322
o/w arrears	363	483	-72	443	---	-100	-100	-100	-100
Wage expenditures (commitment)	1,783	1,767	1,852	1,919	2,018	2,044	2,114	2,177	2,238
o/w arrears	105	212	-72	105	---	---	---	---	---
Nonwage expenditures (commitment)	1,402	1,481	1,578	1,565	1,681	1,702	1,784	1,862	1,941
o/w arrears	259	271	---	338	---	-100	-100	-100	-100
Net lending (commitment)	140	278	146	210	167	242	184	157	143
o/w arrears	---	---	---	---	---	---	---	---	---
Development expenditures (commitment)	370	243	269	187	350	198	305	325	345
o/w arrears	76	32	---	18	---	---	---	---	---
Recurrent balance (commitment, excl. development expenditure)	-1,279	-1,453	-1,424	-1,382	-1,279	-1,395	-1,294	-1,188	-1,087
Overall balance (committment)	-1,649	-1,696	-1,692	-1,568	-1,629	-1,593	-1,600	-1,513	-1,433
Total financing	1,649	1,696	1,692	1,568	1,629	1,593	1,600	1,513	1,433
Net domestic bank financing	93	127	72	-248	---	120	120	121	121
External debt repayment						-14			
External financing for recurrent expenditures	815	774	1,150	1,255	1,329	1,189	1,000	1,000	1,000
External financing for development expenditures	169	156	180	106	300	121	205	218	231
Arrears	571	686	-33	465	---	-100	-100	-100	-100
Residual/Financing gap 2/	1	-47	323	-11	---	277	375	275	180
Memorandum items:	(In percent of GDP, unless otherwise stated)								
Revenues	20.9	20.2	19.8	20.4	21.8	21.6	21.9	22.2	22.5
Recurrent expenditures and net lending	34.0	34.4	32.9	32.6	32.6	33.2	32.1	31.0	30.0
Wage expenditures	18.2	17.2	17.0	17.0	17.0	17.0	16.6	16.1	15.6
Nonwage expenditures	14.3	14.4	14.5	13.8	14.2	14.2	14.0	13.8	13.5
Net lending	1.4	2.7	1.3	1.9	1.4	2.0	1.4	1.2	1.0
Recurrent balance (commitment) before external support	-13.1	-14.2	-13.1	-12.2	-10.8	-11.6	-10.2	-8.8	-7.6
External financing for recurrent expenditures	8.3	7.6	10.6	11.1	11.2	9.9	7.9	7.4	7.0
Development expenditures (cash)	3.0	2.1	2.5	1.5	3.0	1.6	2.4	2.4	2.4
Overall balance (commitment)	-16.9	-16.5	-15.6	-13.9	-13.7	-13.3	-12.6	-11.2	-10.0
Overall balance (cash)	-11.0	-9.8	-15.9	-9.7	-13.7	-14.1	-13.4	-11.9	-10.7
Residual/Financing gap	0.0	-0.5	3.0	-0.1	0.0	2.3	2.9	2.0	1.3
Nominal exchange rate (NIS per US dollar)	3.58	3.86	...	...	...	...	...	...	...
Nominal GDP (in millions of shekels)	34,977	39,541	40,853	40,853	42,674	42,674	44,890	47,573	50,450

Sources: Ministry of Finance; and IMF staff projections.

1/ Includes fuel subsidies.

2/ Financing gaps in the medium-term are expected to be filled by grants that are yet to be identified.

Table 3. West Bank and Gaza: Central Government Fiscal Operations, 2011–17
(GFSM 2001)

	2011	2012	2013	Projections 2014	2015	2016	2017
	(GFSM 2001; in millions of shekels)						
Revenue	10,841	11,576	13,263	13,871	14,084	14,847	15,660
Taxes	6,406	7,035	7,426	8,225	8,759	9,409	10,097
Domestic taxes	1,727	1,852	2,157	2,240	2,339	2,463	2,595
Clearance taxes	5,095	5,617	6,103	6,545	6,880	7,306	7,762
Tax refund	-416	-434	-834	-560	-460	-360	-260
Grants	3,520	3,587	4,915	4,655	4,249	4,279	4,318
External budget support	2,915	2,986	4,532	4,226	3,528	3,514	3,507
External development support	605	601	383	429	722	765	811
Other revenue	915	954	921	991	1,076	1,160	1,245
o/w Dividends	160	120	116	125	135	146	156
Expenditures	13,222	14,530	14,009	14,879	15,478	15,885	16,366
Expense	11,897	13,593	13,336	14,175	14,401	14,744	15,155
Compensation of employees 1/	6,381	6,812	6,928	7,265	7,458	7,649	7,849
Use of goods and services	1,792	2,112	2,148	2,252	2,312	2,371	2,433
Grants 2/	501	1,072	760	860	650	550	500
Other expense 3/	3,223	3,597	3,500	3,798	3,980	4,173	4,373
Net acquisition of nonfinancial assets	1,325	937	674	704	1,077	1,142	1,211
Gross Operating Balance	-1,056	-2,017	-73	-304	-317	104	505
Net lending / borrowing (overall balance)	-2,381	-2,954	-746	-1,008	-1,394	-1,038	-706
Net financial transactions	-2,381	-2,954	-746	-1,008	-1,394	-1,038	-706
Net acquisition of financial assets	---	---	---	---	---	---	---
Domestic							
Currency and deposits	---	---	---	---	---	---	---
Net incurrence of liabilities	2,377	3,136	785	22	72	74	74
Domestic	2,377	3,136	785	70	72	74	74
Loans	334	490	-895	425	425	425	425
Net domestic bank financing	334	490	-895	425	425	425	425
Other accounts payable	2,043	2,646	1,680	-356	-353	-351	-351
Arrears (recurrent)	1,538	2,043	1,628	-356	-353	-351	-351
Arrears (capital)	270	124	66	---	---	---	---
Arrears (clearance)	-235	-479	14	---	---	---	---
Foreign	---	---	---	-48	---	---	---
Loans	---	---	---	-48	---	---	---
Statistical Discrepancy/Financing gap	*4*	*-182*	-38	986	1,322	965	632
Memorandum items:							
Gross operating balance excl. grants (commitment)	-4,576	-5,604	-4,988	-4,959	-4,566	-4,175	-3,814
Gross operating balance excl. grants (cash)	-2,803	-3,082	-3,374	-5,315	-4,919	-4,526	-4,164
Overall balance (NLB) excl. grants (commitment)	-5,901	-6,541	-5,662	-5,663	-5,643	-5,317	-5,024
Overall balance (NLB) excl. grants (cash)	-3,858	-3,894	-3,982	-6,018	-5,996	-5,668	-5,375
Revenue (percent of GDP)	31.0	29.3	32.5	32.5	31.4	31.2	31.0
Expenditure (percent of GDP)	37.8	36.7	34.3	34.9	34.5	33.4	32.4
Expense (percent of GDP)	34.0	34.4	32.6	33.2	32.1	31.0	30.0
Wage expenditure (percent of GDP)	18.2	17.2	17.0	17.0	16.6	16.1	15.6
Nonwage expenditures (percent of GDP)	5.1	5.3	5.3	5.3	5.2	5.0	4.8
GOB (commitment) excluding grants (percent of GDP)	-13.1	-14.2	-12.2	-11.6	-10.2	-8.8	-7.6
GOB (cash) excluding grants (percent of GDP)	-8.0	-7.8	-8.3	-12.5	-11.0	-9.5	-8.3
External support (recurrent)	8.3	7.6	11.1	9.9	7.9	7.4	7.0
in millions of NIS	2,915	2,986	4,532	4,226	3,528	3,514	3,507
NLB (commitment) excluding grants (percent of GDP)	-16.9	-16.5	-13.9	-13.3	-12.6	-11.2	-10.0
NLB (cash) excluding grants (percent of GDP)	-11.0	-9.8	-9.7	-14.1	-13.4	-11.9	-10.7
Total external support (in millions of shekels)	3,520	3,587	4,915	4,655	4,249	4,279	4,318
Nominal GDP (in millions of shekels)	34,977	39,541	40,853	42,674	44,890	47,573	50,450
Exchange Rate	3.6	3.9	3.6	...	...	...	...

Sources: Ministry of Finance; and IMF staff projections.
1/ Wage expenditures.
2/ Grants to local governments related to purchase of water and electricity.
3/ Includes transfers (social benefits) and minor capital.

Table 4. West Bank and Gaza: Financial Soundness Indicators, 2010–14
(In percent)

	Dec-10	Dec-11	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Capital adequacy (for all Banks)								
Tier I capital to risk-weighted assets	23.3	22.9	22.2	21.5	21.2	21.0	21.5	21.1
Regulatory Capital to Risk Weighted Assets	21.4	21.1	20.3	19.8	19.5	19.3	20.0	19.6
Capital adequacy (for local Banks)								
Tier I capital to risk-weighted assets	26.5	24.5	22.7	21.2	20.9	20.5	20.7	20.4
Regulatory Capital to Risk Weighted Assets	21.6	20.3	18.8	17.7	17.7	17.3	17.8	17.5
Asset quality 1/								
Nonperforming loans (percent of total loans)	3.1	2.7	3.1	3.2	3.1	2.9	2.9	2.8
Nonperforming loans net of provisions to capital	2.9	3.8	4.9	4.7	5.1	4.8	4.7	4.8
Coverage ratio (provisions as percent of nonperforming loans)	70.4	60.9	60.1	61.6	59.3	60.5	59.1	58.9
Earnings and profitability								
Return on assets (ROA)	2.1	1.9	1.8	2.0	2.0	2.0	1.9	1.9
Return on equity (ROE) 2/	21.1	17.0	16.2	19.1	18.5	18.8	18.7	18.6
Interest income to gross income	59.4	71.7	72.4	74.0	75.0	74.6	74.0	74.5
Non-interest expenses to gross income	55.0	57.2	55.4	52.8	53.5	54.1	54.8	55.0
Personal Cost to non-interest expenses	55.3	55.5	53.8	57.4	56.9	55.1	53.9	56.3
Liquidity								
Liquid assets to total assets	40.3	38.2	37.5	36.3	36.8	37.5	39.5	38.0
Liquid assets to demand and savings deposits	78.4	74.4	71.6	69.1	69.4	71.1	74.7	72.0
Liquid assets to total deposits	49.1	46.9	45.8	44.6	45.0	45.8	48.1	46.5

Source: Palestine Monetary Authority.
1/ Nonperforming loans includes loans more than 90 day overdue.
2/ Return on equity (ROE) is a ratio of income before extraordinary items and taxes to average Tier 1 capital.

Annex I. Upside Scenario

Successful peace negotiations would open up the prospect of a significant peace dividend, subject to various risks and constraints. Successful completion of the peace negotiations will likely boost domestic and foreign investment, unlock pent-up demand, increase confidence and reduce the risk premium, potentially lifting the WBG economy to a much higher growth path. This upside scenario, however, depends critically on (i) lifting of Israeli restrictions, (ii) private sector buy in, and (iii) sustained donor support. To quantify the peace dividend, we develop an illustrative scenario which assumes that a final status agreement is reached by end 2014 (see text table for detailed assumptions).

Key Assumptions for Upside Scenario[1]

- Final status agreement by end-2014.
- Gradual lifting of Israeli restrictions on internal and external movements of goods and people and access to land and other resources in 2015–17. No net increase in the number of Palestinian workers in Israel and settlements.
- Increase in FDI and domestic private investment of 20 percent of GDP in 2015–17.
- Continuation of current monetary arrangements.
- Additional donor support in the short run. We assume a 50 percent increase in total donor aid (budget and project support) in 2015, phased out in 3 years after which donors provide $1 billion per year to finance the declining recurrent deficit with the remainder allocated for project support.
- Expansion of health and education services to accommodate the phasing-out of UNWRA (from 2017). From 2017 $100 million is added to the PA's budget until all services provided by UNWRA are covered by the PA. UNWRA's budget for the WBG is roughly $450 million per year.
- The PA initiates reforms to reduce fiscal vulnerarabilities and accommodate expansion of public services. These reforms are in addition to ongoing reforms as reflected in the baseline.

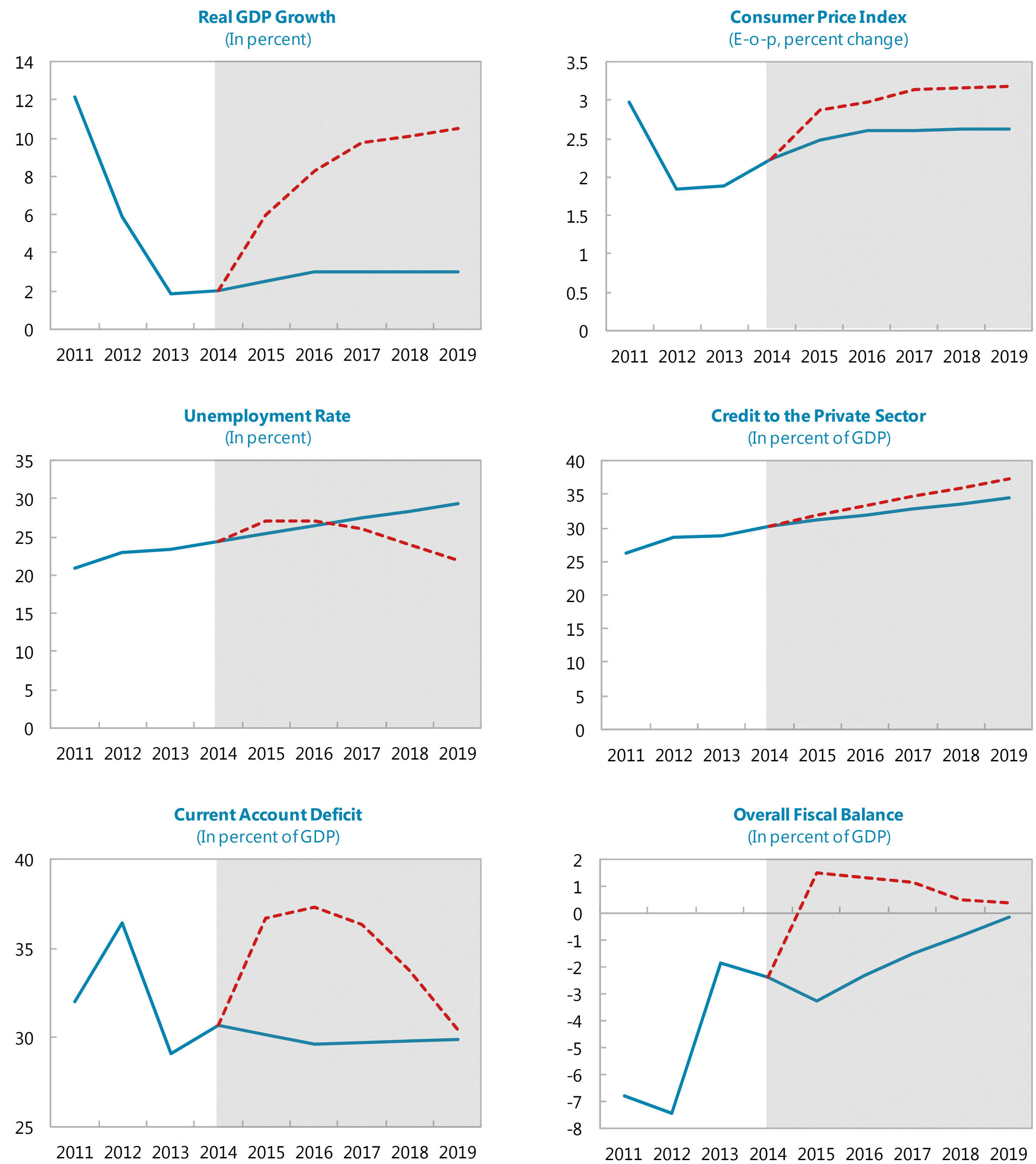
[1] This scenario does not take into account the possible direct costs of specific arrangements of a peace agreement, including on Israeli settlements and Palestinian refugees.

Under this upside scenario economic indicators will improve significantly, but donor support remains needed. Real GDP growth would rise to 6 percent in 2015 and increase further to above 10 in the medium term. Inflation would pick up, but remain in the lower single digits, anchored by modest inflation rates in Israel. Unemployment would remain high at above 20 percent as a result of high labor force growth and existing labor market frictions, assuming there is no net increase in employment of Palestinian workers in Israel. In addition, public finances would improve, with lower deficits coming from higher revenues that are generated by stronger growth and imports. Reliance on budget support would diminish but not disappear.

Existing private and public sector capacity constraints would weigh on the peace-dividend. Large private capital inflows are contingent on a game-changing political environment and an improvement of the business environment, especially in order to attract FDI. Capacity constraints such as the lack of skilled labor and project management experience, and the limited development of key sectors such as construction challenge rapid economic expansion. It is thus essential to improve the efficiency of public investment and the PA's capacity to provide the necessary policy and regulatory framework, including improved systems for procurement and project appraisal, to relieve institutional constraints and strengthen investment efficiency. Furthermore, it is crucial to strengthen the PMA's readiness to counter financial instability that could follow from high demand pressures, higher inflation and real exchange rate appreciation. It is recommended to strengthen macro-prudential surveillance, risk-based supervision, consolidated and cross-border supervision, and the bank resolution framework.

A peace agreement cannot be a substitute for economic reform. High-priority structural reforms need to be taken up urgently to reap the full benefits from a potential peace agreement, minimize the risks, and meet medium-term fiscal challenges. Donors can assist in designing and implementing these reforms in areas that include the pension system, civil service, electricity and fuel subsidies, the system of tax incentives, tax administration, and public financial management. Careful sequencing of reforms will be critical.

Figure A1. West Bank and Gaza: Baseline and Upside Scenarios: Macro Indicators, 2011–19



Source: IMF staff estimates and projections.

Baseline scenario Upside scenario

Annex II. West Bank and Gaza: Technical Assistance by the IMF to the Palestinian Authority, 2010–14

The TA support has been in the areas of public financial management, revenue administration, banking supervision, and national accounts. There was also support to the recently established macro-fiscal unit within the MoF. The priorities over the medium term remain on public financial management, revenue administration, and banking supervision. There is need for intermittent review and assistance to enhance the statistical capacity especially in GFSM 2001, the external sector, and the national accounts expenditures side. It is expected that FAD and MCM will continue to provide TA, dependent on the authorities' commitment and progress, supported by METAC.[1]

Mission Date	Mission	Date of TA Report
Fiscal Sector: Since 2007, numerous reform components of a modern public financial management system have been put in place and steadily upgraded. Significant progress in PFM was made in drafting legal frameworks, adopting the Single Treasury Account (STA), establishing debt management and cash planning units, the modernization of budget classification and Chart of Accounts, developing computerized financial management information system (FMIS), strengthening accounting and reporting, activating internal audit departments in ministries, establishing an independent external audit agency, and establishing a macro-fiscal unit. A medium-term plan of reforms had been agreed upon in 2011 and further updated in 2012. Currently, the key objective is to consolidate the institutionalization of progress already made. Further to consolidation, approval of legislative and regulatory frameworks, review of implementation of commitment control and the STA, cash planning, arrears recording and formulation of strategies for minimizing arrears, and compliance with GFSM 2001 standards need to be addressed. Since 2010, the TA efforts expanded into mobilizing revenue compliance by modernizing tax administration. A medium-term work program, recommended by the FAD, will strengthen particularly the administration of income tax and VAT for the large and medium taxpayer segments, reform the income tax and reduce tax incentives and exemptions. So far, a computerized revenue management system has been launched, a tax procedures code was approved by the Cabinet but not enacted, and the LTU, under a newly appointed director, has begun to operate more effectively. In the medium term, the FAD TA priorities will remain the improvement of public financial management and modernization of revenue administration.		
Mar. 3-16, 2010	Tax Modernization	n.a.
Jun. 9-13, 2010	Inspection and Scoping Mission	n.a.
Aug. 26–Sep. 6, 2010	Public Financial Management Progress Review	Oct. 2010
Oct.17–30, 2010	Completing the Foundations of Modern Revenue Administration	Dec. 2010
Mar. 19–30, 2011	Palestinian Authority Integrated Tax Administration System	Mar. 2011
Jul. 3-7, 2011	Self Assessment Preparations and Progress with its Introduction in LTU	n.a.
Sep. 14–27, 2011	Tax Audits Procedures	Oct. 2011
Sep. 28–Oct. 30, 2011	Improving Compliance with Income Tax	Dec. 2011

Dec. 1–12, 2011	Public Financial Management Progress Review	Jan. 2012
Feb. 1-14, 2012	Tax Administration	n.a.
Apr. 15–22, 2012	Tax Revenues Clearance Procedures	May 2012
Jun. 13–26, 2012	Improving Income Tax and Tax Incentives Proposed Tax Policy TTF	Jul. 2012
Jan. 22–31, 2013	Public Financial Management Progress Review	Jan. 2013
Jun. 25–Jul. 8, 2013	Supplementary Technical Review: Investment Tax Incentives and Tax Expenditure Costs	Jul. 2013
Nov. 24–Dec. 5, 2013	Strengthening LTO Operations	Dec. 2013
Jan. 8–21, 2014	Public Financial Management Reform Agenda 2014–16	Mar. 2014
Monetary and Financial Systems: The TA efforts have been to support the Palestine Monetary Authority (PMA) in becoming a competent monetary authority to operate a high-quality reserves management system, to supervise and regulate banks, to gain capacity in introducing government securities, and to prepare for the eventual introduction of an independent currency for the WBG economy when conditions are right. The PMA established a credit registry, instituted periodic stress testing of banks, introduced a deposit insurance scheme, and prepared plans for contingency crises management. The PMA has developed substantial capacity as a central bank toward the possibility of issuance of a national currency.		
Oct. 16–28, 2010	Support to the Palestine Monetary Authority Credit Registry	Oct. 2010
Oct. 29–Nov. 4, 2010	Reserve Management *	Nov. 2010
Nov. 23–Dec. 2, 2010	Developing the Government Securities Market *	Dec. 2010
Dec. 3–8, 2011	Support to the Palestine Monetary Authority Credit Registry	Dec. 2011
Dec. 8–15, 2011	Enhancing the Capacities of the Palestine Monetary Authority and Options for the Issuance of New Currency and the Monetary Policy Regime *	Mar. 2012
Jan. 15–26, 2012	Developing a Government Securities Market	n.a.
Feb. 5–9, 2012	Reserve Management Policy and Investment Guidelines *	Apr. 2012
Mar. 25–Apr. 3, 2012	Risk-Based Banking Supervision *	Apr. 2012
Oct. 9–18, 2012	Implementing Risk-Based Supervision	Oct. 2012

Oct. 31–Nov. 15, 2012	Strengthening the Stress Testing Framework, Consolidated and Cross Border Supervision and Contingency Crisis Management Framework	Nov. 2012
Dec. 8–12, 2012	Developing the Government Securities Market	Dec. 2012
Jan. 13–17, 2013	Reserve Management Policy and Investment Guidelines	Jan. 2013
Mar. 31–Apr. 11, 2013	Follow up on Risk Based Supervision Manual	n.a.
Jun. 30–Jul. 10, 2013	Follow up on Risk-Based Supervision	n.a.
Nov. 3–14, 2013	Implementing Risk Based Supervision*	Nov. 2013
Nov. 16–26, 2013	Credit Registry	Nov. 2013
May 25–29, 2014	Follow up on Risk Based Supervision Manual	n.a.
Statistics: The TA efforts have been to implement and align existing statistical compilation and dissemination systems with the latest international statistical standards across three major datasets [government finance statistics (GFS), national accounts (NA), and external sector statistics (ESS)] for economic policy analysis. These efforts culminated with WBG joining the IMF's Special Data Dissemination Standard (SDDS) as a subscriber in April 2012. Further work is needed in improving data consistency in ESS, developing an inter-institutional strategic plan for GFSM2001 implementation, and developing a set of high-frequency indicators to detect economic trends and risks. In general, the transparency and timeliness of the data produced by the Palestinian Central Bureau of Statistics, Ministry of Finance, and the PMA compare favorably with countries that maintain good data management and dissemination standards.		
Feb. 2–18, 2010	Balance of Payments Statistics – IIP	n.a.
Apr. 14–27, 2010	Monetary and Financial Statistics	Apr. 2010
Sep. 19–30, 2010	Report on the Government Finance Statistics Mission	Jan. 2011
Dec. 5–16, 2010	External Sector Statistics	Jun. 2011
Oct. 16–27, 2011	Report on the SDDS Assessment Mission	Oct. 2011
Nov. 27–Dec. 1, 2011	Balance of Payments Statistics – IIP	n.a.
Jan. 27–31, 2013	Balance of Payments Statistics – IIP	n.a.
May 18–29, 2014	National Accounts	n.a.
May 21–June 3, 2014	Monetary and Financial Statistics	n.a.

[1] METAC – Middle East Regional Technical Assistance Center.
n.a. – not applicable.
* The reports are classified confidential.